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Report No. 1409
February 19, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Acting Chief Counsel and Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1409 – Report on Proposed Section 59A Regulations*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1409, commenting on the proposed regulations issued by the Internal Revenue Service and the Department of the Treasury under Section 59A of the Internal Revenue Code.

We commend the Internal Revenue Service and the Department of the Treasury for these thoughtful proposed regulations. Our Report is attached, and we include for your convenience as an Appendix a prior Report that we submitted on Section 59A. While our prior report made suggestions for Treasury to consider for regulations, this Report focuses on the proposed regulations and comments requested by Treasury.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

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Report No. 1409

New York State Bar Association Tax Section

REPORT ON PROPOSED SECTION 59A REGULATIONS

February 19, 2019

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<u>**Proposed Section 59A Regulations**</u>[1]

I. Introduction

This Report comments on proposed regulations (the "***Proposed Regulations***")[2] issued by the Department of the Treasury and Internal Revenue Service (together, "***Treasury***") under new Section 59A[3] on December 13, 2018. While our prior report (the "***Prior Report***"),[4] submitted on July 16, 2018, made suggestions for Treasury to consider for regulations under Section 59A, this Report focuses on the Proposed Regulations and comments requested by Treasury.

Part II of this Report contains a summary of our recommendations. Part III contains a detailed discussion of our recommendations. This Report does not provide an overview of the statutory and proposed regulatory framework for Section 59A, but rather addresses specific issues with respect to which we have comments and recommendations. Our comments do not address all aspects of Section 59A and the Proposed Regulations.

II. Summary of Principal Recommendations

The following is a summary of the principal recommendations in this Report, organized by Section of the Proposed Regulations. All terms capitalized in this part have the meanings ascribed to them in Parts I and III of this Report.

<u>**Proposed Regulations Section 1.59A-1**</u>

- We request clarification regarding the application of Proposed Regulations Section 1.59A-1(b)(13) to certain loans and highly leveraged businesses.

<u>**Proposed Regulations Section 1.59A-2**</u>

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1 The principal authors of this report are David Hardy and Eric Wang. The authors would like to acknowledge the support and assistance of Daniel Bleiberg and John Jo in preparing this report. This report reflects comments and contributions from Andy Braiterman, Peter Connors, Michael Farber, Andrew Herman, Stephen Land, Mark Leeds, Jeffrey Maddrey, Deborah Paul, Michael Peller, Yaron Reich, Michael Schler, Michael Shulman, and Karen Gilbreath Sowell. Erika Nijenhuis provided helpful background information.

This report reflects solely the view of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

2 REG-104259-18, Federal Register Vol. 83, No. 245, December 21, 2018 at 65956-65997.

3 Except as otherwise noted, all "***Section***" references in this Report are to sections of the Internal Revenue Code of 1986, as amended (the "***Code***"), references to "***Treasury Regulations***" are to the Treasury Regulations promulgated thereunder, and references to "***Proposed Regulations***" are to proposed Regulations.

4 New York State Bar Association Tax Section Report No. 1397, Report on Base Erosion and Anti-Abuse Tax (July 16, 2018). We have attached the Prior Report hereto as an Appendix for ease of reference.

- We recommend that Section 988 losses be included in the denominator of the Base Erosion Percentage to the extent that such losses arise out of transactions with unrelated parties.

- We request clarification regarding the application of the mark-to-market rule of Proposed Regulations Section 1.59A-2(e)(3)(vi) to physical securities, repurchase agreements and securities loans.

Proposed Regulations Section 1.59A-3

- We recommend that exchanges described in Section 351, liquidations described in Sections 332 and reorganizations described in Section 368 generally should not give rise to Base Erosion Payments, and that final regulations augment the applicable anti-abuse rules to prevent taxpayers or their related parties from engaging in related-party transactions that step up the basis of assets prior to engaging in such transactions.

- We recommend that the exception from the definition of Base Erosion Payment for payments made with respect to TLAC securities also apply to interest payments made with respect to certain other types of debt instrument that certain banks are required to issue pursuant to similar regulatory rules.

- We recommend that property and casualty losses incurred by insurance companies pursuant to reinsurance arrangements not be treated as Base Erosion Payments but suggest that Treasury should consider whether such losses arising from transactions with unrelated parties ought to be taken into account in the denominator of the Base Erosion Percentage.

- We suggest that Treasury consider treating netting arrangements as giving rise to a single payment for purposes of Section 59A where the underlying economic arrangement is that parties to a transaction exchange net value in the form of a single payment (as opposed to engaging in multiple value-for-value exchanges and netting contemporaneous cash payments).

- We request clarification that global dealing allocations under Proposed Treasury Regulations Section 1.482-8 and, in comparable cases, allocations that result from the use of the profit split methods under Section 482 and Treasury Regulations Section 1.482-6 are treated as allocations of income, rather than payments among related entities, for purposes of Section 59A.

- We recommend that the exclusion under Section 59A(c)(2)(B) from the definition of Base Erosion Payment for amounts that are subject to full withholding be interpreted to apply to any Excess Interest subject to full withholding under Section 884.

- We recommend that, subject to the considerations discussed below, where a payment is made to a CFC, and the payment results in a current inclusion to a U.S. taxpayer of either Subpart F income or GILTI, such payment not be treated as a Base Erosion Payment.

- We recommend that final regulations not treat a transfer of property to a foreign related party resulting in a recognized loss as a Base Erosion Payment, and if final regulations do treat such transfers as Base Erosion Payments, we request that Treasury include illustrative examples and clarify that a loss recognized on the transfer of property to a foreign related party only gives rise to a Base Erosion Payment if the loss is utilized by the taxpayer.

- We recommend that the rule in Proposed Regulations Section 1.59A-3(b)(2)(iii) applying the Mark-to-Market Rule to determining the amount of Base Erosion Payments be withdrawn.

<u>Proposed Regulations Section 1.59A-5</u>

- We recommend that final regulations provide that the BEAT Tax Rate for a fiscal year taxpayer for its taxable year that begins in calendar year 2018 is 5% for the entire taxable year.

<u>Proposed Regulations Section 1.59A-6</u>

- We recommend that (i) repurchase premium and rebate interest amounts paid with respect to securities lending transactions and sale-repurchase transactions be excluded from the definition of Qualified Derivative Payment and (ii) securities loans be treated as "derivatives" for purposes of Section 59A that accordingly may give rise to Qualified Derivative Payments.

<u>Proposed Regulations Section 1.59A-7</u>

- We request that Treasury clarify that an acquisition by a partnership in exchange for issuing its own interest may give rise to a Base Erosion Payment based on a deemed exchange by the other partners of their proportionate share of partnership assets rather than based on the fact that the partnership exchanged its own interest.

III. Detailed Discussion of Recommendations

A. Proposed Regulations Section 1.59A-1

1. Aggregate group definition

Proposed Regulations Section 1.59A-1 provides a definition of an "aggregate group" of corporations (an "***Aggregate Group***"). This definition is relevant for applying the gross receipts test of Section 59A(e)(1)(B) (the "***Gross Receipts Test***") and the base erosion percentage test of Section 59A(e)(1)(C) (the "***Base Erosion Percentage Test***") to corporations that are members of such a group. In general, payments between members of an Aggregate Group are not included in the gross receipts of the Aggregate Group, and payments between members of the Aggregate Group are not taken into account for purposes of the numerator or the denominator of the Base Erosion Percentage Test.[5]

Under the Proposed Regulations, an Aggregate Group is defined as a controlled group of corporations as defined in Section 1563(a), subject to certain modifications, including that 50% (rather than 80%) common ownership (by vote or value) is required.[6] An Aggregate Group includes foreign corporations to the extent that such corporations have income that is effectively connected with the conduct of a trade or business in the United States ("***ECI***") or are otherwise subject to U.S. net income taxes under an applicable tax treaty.[7]

In the Prior Report, we suggested that regulations should confirm that transactions between members of a group that is a controlled group for purposes of Section 59A are excluded from the calculation of the Base Erosion Percentage. We applaud the fact that the Proposed Regulations adopt such an approach.[8]

2. Bank or registered securities dealer de minimis exception

Section 59A(e)(1)(C) generally provides that the Base Erosion Percentage Test is satisfied if an applicable taxpayer within the meaning of Section 59A(e)(1) (an "***Applicable Taxpayer***") has a base erosion percentage as determined under Section 59A(e)(4) (a "***Base Erosion Percentage***") of 3% or higher, but in the case of a taxpayer that is a member of an affiliated group that includes a bank or registered securities dealer, the Base Erosion Percentage Test is satisfied if a taxpayer or Aggregate Group has a Base Erosion Percentage of 2% or higher.[9] The Proposed Regulations establish a de minimis exception to the latter rule by providing that an Aggregate Group that includes a bank or registered securities dealer that is a member of an affiliated group is not treated as including a bank or registered securities dealer for purposes of the Base Erosion Percentage Test if, in a taxable year, the total gross receipts of the Aggregate Group attributable to the bank or registered securities dealer represent less than 2% of the total gross receipts of the Aggregate Group.[10] When there is no Aggregate Group, the same rule applies, *mutatis mutandis*, to a consolidated group.[11] We believe that this rule is a sensible interpretation of the statute.

3. Gross receipts definition

The Proposed Regulations define "gross receipts" by reference to the definition contained in Temporary Treasury Regulations Section 1.448-1T(f)(2)(iv).[12] That definition is

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5 Preamble at 65957.

6 Proposed Regulations Section 1.59A-1(b)(1)(i).

7 Proposed Regulations Section 1.59A-1(b)(1)(ii).

8 Proposed Regulations Section 1.59A-2(c); Preamble at 65957.

9 *See also* Section 59A(b)(3)(B).

10 Proposed Regulations Section 1.59A-1(e)(2)(iii).

11 *Id.*

12 Proposed Regulations Section 1.59A-1(b)(13).

used, pursuant to Section 448(c)(1), to determine whether taxpayers are eligible to employ the cash receipts and disbursements method of accounting.

Although Section 59A(e)(2)(B) makes reference to Section 448, Section 59A does not directly define gross receipts by reference to the definition in Section 448. Instead, Section 59A(e)(2)(B) references several provisions of Section 448, such as the provision that addresses the treatment of returns and allowances.[13]

In the Prior Report, we noted that additional guidance would need to be provided in order to determine a corporation's gross receipts, particularly for banks and other financial services corporations.[14] We also noted that for certain highly leveraged businesses, such as banks and other financial intermediaries, the gross receipts amount may not provide a true measure of the size of a taxpayer's U.S. business. For instance, under the applicable definition referenced in the Proposed Regulations, while the repayment of a loan made by a bank is not considered gross receipts, a bank selling a loan is not permitted to reduce gross receipts by the bank's basis in the loan. This rule may lead to unexpected and potentially inappropriate results. It is unclear from the discussion in the Preamble whether such results were intended.

B. Proposed Regulations Section 1.59A-2

Proposed Regulations Section 1.59A-2 contains rules for determining whether a taxpayer is an Applicable Taxpayer, including rules regarding the Gross Receipts Test and the Base Erosion Percentage Test.

1. Section 988 losses

The Proposed Regulations provide that foreign exchange losses under Section 988 are not treated as base erosion payments within the meaning of Section 59A(d)(1) ("***Base Erosion Payments***")[15] and also are not treated as deductions that are added to the denominator that is used in the Base Erosion Percentage Test pursuant to Section 59A(c)(4)(A)(ii)(I).[16] We agree with Treasury that Section 988 losses do not present the same base erosion concerns as other deductions, and accordingly we agree with Treasury's decision not to include Section 988 losses in the numerator of the Base Erosion Percentage and not to treat such losses as Base Erosion Payments.

However, we disagree with the exclusion of Section 988 losses from the denominator of the Base Erosion Percentage where such losses arise from transactions with unrelated parties. The gross amount of such losses appears to continue to be properly

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13 Notably, Section 59A(e)(2)(B) specifically references certain rules of Section 448(c)(3): "[r]ules similar to the rules of subparagraphs (B), (C), and (D) of section 448(c)(3) shall apply in determining gross receipts for purposes of this section." Subparagraphs (B), (C), and (D) provide rules for short taxable years, reductions of gross receipts, and treatment of predecessors, respectively.

14 Prior Report at 8.

15 Proposed Regulations Section 1.59A-3(b)(3)(iv).

16 Proposed Regulations Section 1.59A-2(e)(3)(ii)(D).

deductible.[17] In the case of several other categories of payments that are not treated as base eroding, only payments that are made to related parties and thus excluded from the numerator are similarly excluded from the denominator. For example, as discussed below, service cost method amounts that are excluded from the numerator of the Base Erosion Percentage by application of Proposed Regulations Section 1.59A-3(b)(3)(i) are also excluded from the denominator,[18] but other service cost method amounts may be included in the denominator. Similarly, deductions for qualified derivatives payments[19] and deductions for amounts paid or accrued to foreign related parties with respect to TLAC securities[20] are excluded from the denominator of the Base Erosion Percentage only if also excluded from the numerator.

We agree with the treatment of these other deductible amounts and see no reason to differentiate Section 988 losses arising with respect to transactions with unrelated parties. To the extent that Treasury is concerned that including Section 988 losses in the denominator of the Base Erosion Percentage could cause taxpayers to enter into potentially offsetting transactions with unrelated parties that inflate the denominator without reflecting the taxpayer's actual economic exposure, we note that the anti-abuse rule of Proposed Regulations Section 1.59A-9(b)(2) would generally disregard any transaction, plan or arrangement that has "a principal purpose of increasing the deductions taken into account for purposes of" the Base Erosion Percentage computation.[21]

Further, we note that the exclusion of all foreign exchange losses from both the numerator and the denominator of the Base Erosion Percentage could have a significant impact on certain taxpayers, in particular, on dealers in foreign currency derivatives. Without such losses, these taxpayers may have a limited amount of deductions in the denominator that may not be representative of their overall business, leading to unexpected and unintended results.

2. Mark-to-market transactions

The Proposed Regulations generally provide that in the case of any position with respect to which the taxpayer (or Aggregate Group that includes the taxpayer) applies a mark-to-market method of accounting for federal income tax purposes, all income, deductions, gains or losses on each transaction for the year are combined to determine the amount of the

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[17] Including Section 988 losses in the denominator of the Base Erosion Percentage only to the extent in excess of Section 988 gains—as opposed to including the gross amount of Section 988 losses—could cause the deductions reflected in the denominator not to be representative of the deductions of the taxpayer and additionally could require an imprecise determination of the extent to which such net losses arise out of transactions with related parties.

[18] Proposed Regulations Section 1.59A-2(e)(3)(ii)(B).

[19] Proposed Regulations Section 1.59A-2(e)(3)(ii)(C).

[20] Proposed Regulations Section 1.59A-2(e)(3)(ii)(E).

[21] *See also* Proposed Regulations Section 1.59A-9(c)(5) (illustrating that where a taxpayer, with a principal purpose of increasing the deductions taken into account for purposes of the denominator of the Base Erosion Percentage, enters into offsetting long and short positions with unrelated parties with respect to the same asset, the anti-abuse rule of Proposed Regulations Section 1.59A-9(b)(2) applies such that the transactions are not taken into account for purposes of calculating the denominator of the Base Erosion Percentage).

deduction that is used for purposes of calculating the Base Erosion Percentage (the "***Mark-to-Market Rule***").[22] We believe this rule reaches a sensible outcome with respect to derivatives by avoiding double-counting both a current mark-to-market loss as well as a future payment to which the current loss relates. For example, if an interest rate swap is marked to market for a loss of $50, because the taxpayer will have to make five future payments that are above-market by $10, then taking both the $50 loss into account and the series of $10 payments in the future into account in the denominator of the Base Erosion Percentage would result in double-counting, because, assuming market conditions do not otherwise change, each payment causes the swap's value to increase toward par, and that increase is captured by a mark-to-market gain. However, by causing the taxpayer in future years to offset, for purposes of Section 59A, the deduction associated with each above-market payment and corresponding mark-up of the swap as a result of the reduced volume of above-market payments owed in the future, the taxpayer takes into account the full economic loss associated with the swap in the first year but does not take any additional losses with respect to the swap into account in the future.[23]

However, the Mark-to-Market Rule by its terms could also be read to apply to physical securities (stocks and bonds), as well as repurchase agreements (also known as "repos") and securities loans with respect to which a taxpayer applies a mark-to-market method of accounting. It is not clear whether Proposed Regulations Section 1.59A-2(e)(3)(vi) should apply to such transactions, because unlike in the case of many derivatives, such transactions generally do not entail a loss of value to the holder of the relevant instrument that is subsequently crystallized in the form of a payment made by the holder and that effectively gives rise to an offsetting mark-up of the security. The Mark-to-Market Rule accordingly is not necessary to avoid the double-counting of deductions in such transactions. For example, assume that a share of stock in a company is worth $100 in Year 0, when a dealer buys the share; in Year 1, the share price drops to $90 and the company pays a $1 dividend with respect to the share; and in Year 2, the dealer sells the share for $90. In the absence of the Mark-to-Market Rule, the amount of the dealer's deduction in Year 1 would be $10; with the application of the Mark-to-Market Rule, however, the amount of the deduction is $9. Because for non-BEAT purposes the dealer would have either a $10 loss on a non-mark-to-market basis (in Year 2), or would have a $10 loss on a mark-to-market basis (in Year 1) without treating the amount of the $1 dividend as an offset to the loss, it seems that the deduction for BEAT purposes should be $10. Rather than preventing double-counting, the effect of the Mark-to-Market Rule in such a situation is to net amounts that would not be netted under Section 475 and that are not duplicative of other inclusions or deductions by the taxpayer.

Similarly, to take another example, assume that a dealer sells a share of stock short in Year 0, when the share is worth $100; in Year 1, the value of the share drops to $90, and the dealer pays a $1 substitute dividend. Absent the Mark-to-Market Rule, the dealer would have a $1 deduction. Applying the Mark-to-Market Rule, the dealer has a net gain of $9 and no

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22 Proposed Regulations Section 1.59A-2(e)(3)(vi).

23 This outcome is generally consistent with the treatment of a derivative held by the taxpayer for purposes of the Code other than Section 59A, including under Section 475(a), because deductions for payments made over the life of the derivative generally would correspond to mark-to-market gains associated with a decrease in the amount of payments owed on a going-forward basis.

deduction. Once again, on a non-mark-to-market basis, or applying mark-to-market principles for non-BEAT purposes, the dealer would have a gain of $10 and a $1 deduction.

We note that the Mark-to-Market Rule would be adverse to a taxpayer where a payment to the taxpayer effectively reduces the amount of a third-party deduction that would be included only in the denominator of the Base Erosion Percentage, but the Mark-to-Market Rule would be beneficial to a taxpayer where a deduction that would otherwise have been added to both the numerator and the denominator of the Base Erosion Percentage in the absence of the Mark-to-Market Rule is netted to a smaller amount, or becomes income rather than a deduction.

We request clarification from Treasury regarding whether Proposed Regulations Section 1.59A-2(e)(3)(vi) applies to the various types of transactions described above.

C. Proposed Regulations Section 1.59A-3

Proposed Regulations Section 1.59A-3(b)(1) defines Base Erosion Payment and base erosion tax benefit (within the meaning of Section 59A(c)(2)) (a "***Base Erosion Tax Benefit***").

1. Payments or accruals of non-cash consideration in nonrecognition transactions

Consistent with Section 59A(d)(2), Proposed Regulations Section 1.59A-3(b)(1)(ii) provides that the term Base Erosion Payment includes "[a]ny amount paid or accrued by the taxpayer to a foreign related party of the taxpayer in connection with the acquisition of property by the taxpayer from the foreign related party if the character of the property is subject to the allowance for depreciation (or amortization in lieu of depreciation)." Proposed Regulations Section 1.59A-3(b)(2) provides that for purposes of the definition of Base Erosion Payment, "an amount paid or accrued includes an amount paid or accrued using any form of consideration, including cash, property, stock, or the assumption of a liability."

The preamble to the Proposed Regulations (the "***Preamble***") states that an accrual by a taxpayer to a foreign related party may be a Base Erosion Payment under the definition contained in the Proposed Regulations even if the accrual is in the form of non-cash consideration and even if the transaction qualifies under a nonrecognition provision of the Code. Thus, for example, the Preamble states that a Base Erosion Payment could result where a domestic corporation acquires depreciable assets from a foreign related party in an exchange described in Section 351, a liquidation described in Section 332, or a reorganization described in Section 368.[24] The Preamble notes that "[t]he statutory definition of this type of Base Erosion Payment that results from the acquisition of depreciable or amortizable assets in exchange for a payment or accrual to a foreign related party is based on the amount of imported basis in the

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[24] Preamble at 65960.

asset. That amount of basis is imported regardless of whether the transaction is a recognition transaction or a transaction subject to rules in subchapter C or elsewhere in the Code."[25]

We believe that Treasury's sole focus on the "import" of basis into the U.S. is misguided and that, both from a policy perspective and from a technical standpoint, the types of nonrecognition transactions enumerated in the Preamble generally should not give rise to Base Erosion Payments. These transactions can be divided into two different types: those in respect of which the transferor of the depreciable asset disappears and those in respect of which the transferor stays in existence. We first address transactions in respect of which the transferor disappears.

A nonrecognition transaction in respect of which the transferor of the depreciable asset disappears, such as a tax-free liquidation of a foreign subsidiary into its U.S. parent described in Section 332 (an "***Inbound 332 Transaction***"), or a reorganization of a foreign corporation into a U.S. corporation described in Section 368(a)(1)(F) (an "***Inbound F Reorganization***"), should not give rise to Base Erosion Payments. As a policy matter, subjecting such transactions to BEAT is questionable, because these transactions are adding presumably income-generating assets to the U.S. tax base, such that depreciation deductions with respect to such assets, when taken together with the income intended to be generated, will not necessarily cause the assets to erode the U.S. tax base.[26] Further, where the transferor foreign party disappears, there is no real transfer of value from the U.S. party to a foreign related party. In an Inbound 332 Transaction, the foreign subsidiary distributes all of its assets in complete cancellation or redemption of its stock and immediately ceases to exist. Similarly, in an Inbound F Reorganization, the foreign corporation is treated as forming a new U.S. corporation, contributing all of the foreign corporation's assets to the U.S. corporation in exchange for stock, and then immediately distributing such stock to the shareholders of the foreign corporation.[27] In both cases, all that has happened is that the foreign corporation's assets and future income have become those of a U.S. corporation, such that there has, in the aggregate, likely been a base

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[25] *Id.*

[26] We acknowledge that it is not dispositive that such transactions generally enhance the U.S. tax base, because certain types of payments that are unambiguously subject to BEAT by the terms of Section 59A, such as royalty and interest payments, generally enhance the U.S. tax base insofar as such payments support the use of assets by a U.S. payor: in the case of royalties, the right to use intellectual property may result in increased gross income from the use of the intellectual property for the U.S. payor, and in the case of interest, the use of cash lent to the U.S. payor similarly may give rise to increased gross income.

[27] The case where a non-U.S. corporation redeems shares owned by a U.S. parent corporation in an Inbound 332 Transaction is closely analogous to a distribution of property by a foreign corporation that is not in redemption of stock. The Preamble states with respect to such distributions that "for transactions in which a taxpayer that owns stock in a foreign related party receives depreciable property from the foreign related party as an in-kind distribution subject to section 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. Thus, there is no payment or accrual." Preamble at 65960. It may be helpful to taxpayers for final regulations to clarify that a distribution of stock to which Section 355(a) applies also does not give rise to a Base Erosion Payment. We also request clarification regarding whether distributions in redemption of stock that are treated as distributions of property by application of Section 302(d) (including deemed distributions that are so treated by application of Section 304(a)) are treated as giving rise to Base Erosion Payments.

enhancement rather than base erosion, and no foreign related party has obtained anything of value.

As a technical matter, Section 59A(d)(2) requires that an amount treated as a Base Erosion Payment be "paid or accrued" by the taxpayer. In the context of Section 59A, a payment or accrual would seem to entail that there be a recipient of the payment or accrued amount, and such recipient must be related to the taxpayer. As discussed above, however, in both an Inbound 332 Transaction and an Inbound F Reorganization, no recipient remains once the "payment" has been made. Moreover, the only potential "payment" is the non-U.S. corporation's own stock, which ceases to exist for U.S. tax purposes in the hands of the payee. Thus, a technical analysis of the language of Section 59A(d)(2) supports not treating such transactions as giving rise to Base Erosion Payments. In addition, in the deemed transactions occurring in an Inbound F Reorganization described above, the foreign corporation and U.S. corporation are only "related" within the meaning of Section 59A(g) for the instant in which both corporations are deemed to exist, further calling into question the existence of a payment to a foreign related payee.

The appropriate treatment of nonrecognition transactions where the transferor of the depreciable asset continues to exist and to be related to the U.S. taxpayer after the payment has been made is somewhat less clear. However, in these situations, the purposes of Section 59A are not necessarily served by treating the U.S. taxpayer as making a base-eroding payment. For example, where assets are transferred to a U.S. corporation, such as in a contribution of assets by a foreign person to a U.S. corporation in a transaction described in Section 351 (an "***Inbound 351 Contribution***") or in a reorganization described in Section 368(a)(1)(A) (an "***Inbound Asset Reorganization***"), no assets have left U.S. corporate solution that could have contributed to the U.S. tax base at a later time, because the consideration paid by the U.S. corporation is its own stock. Although depreciation of the transferred assets by the U.S. corporation may subsequently give rise to deductions, the use of the transferred assets by the U.S. corporation could give rise to gross income, the sale or exchange of the transferred assets by the U.S. corporation could give rise to the recognition of taxable gain, and a dividend of such gross income or sale or exchange proceeds would not be deductible to the U.S. corporation. More broadly, we believe that to subject Inbound 351 Contributions to BEAT would disincentivize equity investments in U.S. corporations, running contrary to the central objectives of the Tax Cuts and Jobs Act[28] (the "***TCJA***") of making U.S. corporations more globally competitive and broadening the U.S. tax base.[29] On the other hand, we acknowledge that it is difficult to draw a distinction between an Inbound 351 Contribution and a situation where a foreign parent company contributes cash to its U.S. subsidiary, which cash is then used to acquire depreciable property from a related foreign party. One possible way to distinguish the two situations is that, in the case of an Inbound 351 Contribution, the depreciable basis of the contributed assets has no relation to the value of the shares issued, because the basis of the contributed assets is determined by reference to their basis in the hands of the contributor.

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[28] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution the budget for fiscal year 2018, P.L. 115-97.

[29] *See* Unified Framework for Fixing Our Broken Tax Code (Sept. 27, 2017), https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf.

We have also considered whether an exclusion of nonrecognition transactions, in particular the exclusion of Inbound 351 Contributions, from BEAT might allow taxpayers to readily avoid Section 59A(d)(2). For example, it is possible that if an Inbound 351 Contribution were not treated as giving rise to a Base Erosion Payment, then, instead of a foreign parent contributing cash to a U.S. corporation which the U.S. corporation then uses to buy a depreciable asset from a foreign related person in a transaction that would be subject to Section 59A, a U.S. corporation could use its own stock to acquire an asset from a foreign person (rather than using cash, which would give rise to a Base Erosion Payment), and the foreign parent of the U.S. corporation could then use cash to purchase the newly issued stock from the foreign person, with the effect that the U.S. corporation acquired an asset using proceeds traceable to the foreign parent, even though no Base Erosion Payment was made. However, we believe that existing law and augmented anti-abuse rules under Section 1.59A-9 of the Proposed Regulations may be sufficient to address such potential abuse. For example, the statutory requirements to qualify for a contribution described in Section 351 impose a constraint on foreign corporations' flexibility to prevent Base Erosion Payments from being made when assets are transferred to a U.S. corporation in exchange for stock. Unless the applicable asset itself has sufficiently large value to give the transferor control of the U.S. corporation immediately after the transfer, the asset likely needs to be transferred first to a foreign corporation that already has control of the U.S. corporation, and such transfer may be limited by foreign law and non-tax law considerations. In another example, prior to bringing depreciable assets into the U.S. in an Inbound 351 Contribution or an Inbound Asset Reorganization, a taxpayer may attempt to step up the basis of such assets by engaging in intercompany transactions with foreign affiliates. Setting aside potential foreign and non-tax law constraints, the anti-abuse rule that disregards abusive conduit transactions under Proposed Regulations Section 1.59A-9(b)(1) may prevent such a basis step-up.[30] Lastly, we note that the importing of loss assets is restricted by Section 362(e), and we do not believe that Section 59A is an appropriate venue for adding additional protections if any were needed. Thus, we believe that, on balance, Inbound 351 Contributions and Inbound Asset Reorganizations should not be treated as Base Erosion Payments. We recommend that the anti-abuse rules of Proposed Regulations Section 1.59A-9 be augmented to prevent taxpayers or their related parties from engaging in related-party transactions that step up the basis of assets prior to engaging in an Inbound 351 Contribution or an Inbound Asset Reorganization.

A technical reading can support our approach. The U.S. corporation's own stock in the context of Inbound 351 Contributions or Inbound Asset Reorganizations is not, in our view, the sort of asset of the U.S. corporation that should be treated as "paid or accrued" to a foreign related person "in connection with the acquisition . . . of property" under Section 59A(d)(2). The Code uses the phrase "paid or accrued" in numerous places by referring to a transfer of property that is deductible or taxable.[31] In addition, the heading to Section 59A(d)(2),

[30] We acknowledge that because the conduit anti-abuse rule requires that the payment or accrual by the taxpayer be made to an intermediary, there exists some tension between our view below that the phrase "paid or accrued" should not apply to stock issued in a nonrecognition transaction and the applicability of the conduit rule here. Some clarification or augmentation of this anti-abuse rule may be warranted.

[31] *See, e.g.*, Section 162 (trade or business expenses): deduction allowed for "all the ordinary and necessary expenses paid or incurred…"; Section 163 (interest deduction): "all interest paid or accrued . . . ."

"Purchase of Depreciable Property," further connotes[32] that the "acquisition of property" therein refers to a taxable transaction given that a "purchase" generally means a taxable transaction.[33] Thus, we believe that the terms of Section 59A(d)(2) support our belief that the transfer of stock in a nonrecognition transaction should not give rise to any Base Erosion Payment or Base Erosion Tax Benefit.[34]

It is unclear whether a taxable distribution to a U.S. corporation in liquidation of a foreign corporation described in Section 331 (an "***Inbound 331 Transaction***") should give rise to any Base Erosion Payments. Although there is a step up (or step down) in basis of assets in connection with such a transaction (unlike in the case of an Inbound 351 Contribution or an Inbound Asset Reorganization), the overall impact of any Inbound 331 Transaction is that there is an increase in the U.S. tax base, because the foreign corporation's assets and future income have become those of a U.S. corporation without any corresponding assets leaving the U.S. In addition, the same technical analysis as above (relating to the Inbound 332 Transaction) with respect to the questionable existence of a payment, where both the foreign corporation as payee and the foreign corporation's stock disappear immediately after the transaction, applies with equal force to an Inbound 331 Transaction. However, we acknowledge that taxable transactions generally can give rise to Base Erosion Payments under certain circumstances, and we do not take a view regarding whether Inbound 331 Transactions should give rise to Base Erosion Payments.

We also considered whether a taxable transfer of assets to a U.S. corporation in exchange for stock (*e.g.*, a "busted 351") should be subject to BEAT. A corporation's own stock does not seem to be a payment of value with respect to the corporation for purposes of an acquisition. However, it is clear that deductible payments (such as payments of royalties) can be made with a corporation's own stock, and those transactions are clearly subject to BEAT, and accordingly we agree that transfers of stock in exchange for depreciable assets should constitute Base Erosion Payments. Similarly, in the case of a transfer of assets to a corporation that is partially taxable to the transferor pursuant to Section 351(b) as a result of the receipt of "boot" by the transferor, it would be appropriate to treat the corporation as making a Base Erosion Payment because, at that point, there will have been an acquisition in exchange for property of the U.S. corporation and potentially a basis consequence to the U.S. corporation on account of the payment of boot.

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[32] While not having the force of law, a title or heading nonetheless "can aid in resolving an ambiguity in the legislation's text." *INS* v. *National Center for Immigrants' Rights*, 502 U.S. 183, 189-90 (1991) (citing *Mead Corp.* v. *Tilley*, 490 U.S. 714, 723 (1989) and *FTC* v. *Mandel Bros., Inc.*, 359 U.S. 385, 388-89 (1959)); *see also* 1 MERTENS LAW OF FED. INCOME TAX'N § 3:15 ("The title of a statute cannot limit the statute's plain meaning, but it can be used to help interpret an ambiguous provision."); *cf.* Section 7806 (providing that "descriptive matter" relating to the contents of the Code shall not be given "any legal effect").

[33] *See, e.g.*, Section 1091(a); Section 338.

[34] We note that the existence of a taxable transaction distinguishes the use of a corporation's own stock to make a deductible payment from an Inbound 351 Contribution of depreciable property, even though both cases involve a deduction to the U.S. taxpayer in (direct or indirect) connection with the transaction pursuant to which stock is transferred.

Finally, we considered the issue of assumptions of liabilities in relation to the nonrecognition transactions described above. On the one hand, when a U.S. corporation assumes liabilities, the corporation appears to have given up something of value such that a payment has been made. On the other hand, except where the assumption of liabilities is treated as boot, the carry-over basis of the assets has little reference to the value of the liabilities assumed. We ask Treasury to consider these issues when drawing the lines described above, but we make no recommendation either way in this respect.

To the extent that final regulations adopt the treatment described in the Preamble rather than our recommendations, we request clarification in the text of the final regulations, including by way of examples. In addition, we recommend that if final regulations adopt the treatment described in the Preamble, the exception in Proposed Regulations Section 1.59A-3(b)(3)(iii) should be expanded to provide that where a U.S. corporation exchanges its own stock for depreciable assets that gave rise to ECI in the hands of the payee of the stock, no Base Erosion Payment is treated as being made.

2. Service cost method payments

Section 59A(d)(5) provides that a payment for services that are eligible for the services cost method under Section 482 is not treated as a Base Erosion Payment if the amount of the payment constitutes the total services cost with no markup component. The Preamble notes that Section 59A(d)(5) is ambiguous regarding whether, in the case of a payment a portion of which is eligible for the services cost method but that also includes a markup component, the entire payment is ineligible for the exception or only the markup component is ineligible for the exception.[35]

The Proposed Regulations provide that where a payment for services includes a markup component, the exception under Section 59A(d)(5) applies to the portion of the payment that does not exceed the total cost of services.[36] We believe that this provision sensibly interprets the statutory language by permitting a payment to be disaggregated into different "amounts," as described in the statute.

3. TLAC securities

Proposed Regulations Section 1.59A-3(b)(3)(v)(A) provides that a portion of the interest paid or accrued on "total loss-absorbing capacity" ("***TLAC***") securities that certain global systemically important banking organizations are required by the Federal Reserve to issue are not treated as Base Erosion Payments. The amount of interest paid or accrued on TLAC securities that is excluded from treatment as a Base Erosion Payment is limited to the product of the amount paid or accrued to foreign related parties with respect to the TLAC securities and the "scaling ratio."[37] The scaling ratio generally equals the ratio of the minimum amount of debt

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35 Preamble at 65961.

36 Proposed Regulations Section 1.59A-3(b)(3)(i).

37 Proposed Regulations Section 1.59A-3(b)(3)(v)(B).

that is required under the TLAC regulations to the sum of the adjusted issue prices of all TLAC securities issued and outstanding by the taxpayer.[38]

The Preamble explains that "because of the special status of TLAC as part of a global system to address bank solvency and the precise limits that Board regulations place on the terms of TLAC securities and structure of intragroup TLAC funding, it is necessary and appropriate to include an exception to Base Erosion Payment status for interest paid or accrued on TLAC securities required by the Federal Reserve."[39] Because the global system to address bank solvency also has been implemented in jurisdictions outside the United States and could in certain instances give rise to related-party interest expense that is allocable to ECI of issuers that are not U.S. corporations, we believe that it would be appropriate to expand the TLAC exception such that it applies to TLAC securities that are required to be issued pursuant to the TLAC regimes in non-U.S. jurisdictions.

Furthermore, as we stated in the Prior Report, it would be appropriate to expand this exception to interest payments made with respect to certain other types of debt instrument that certain banks are required to issue pursuant to similar regulatory rules.[40] For example, U.S. subsidiaries of a foreign bank generally are required to hold "high-quality liquid assets," and such assets are often held in the form of sale-and-repurchase transactions with the foreign parent bank that are treated as secured debt for U.S. tax purposes. There does not appear to us to be any reason to distinguish this sort of debt from TLAC funding if the concept is to exempt regulatory debt from BEAT. As we noted in the Prior Report, such debt is often issued where banks source long-term funding from third parties at the top-tier entity and onlend to branches and subsidiaries as needed, and as we previously recommended, an exception for such debt would be appropriate so long as the ultimate capital provider is not a related party.

In addition, we note that some smaller banks that are not required by the Federal Reserve to issue TLAC securities nonetheless may choose to issue similar securities out of financial prudence, and the Proposed Regulations as drafted may discourage such prudence in the absence of a broader exception. If Treasury were to consider expanding the TLAC exception to apply to such securities, it would be appropriate for the exception to apply where the top-tier entity borrows from third parties.

4. Insurance claims

a) Deductions vs. reductions in gross income

The Preamble notes that in the case of an insurance company other than a life insurance company, claims payments made to a foreign related insurance company pursuant to a reinsurance arrangement may be treated as reductions in gross income under Section 832(b)(3),

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38 Proposed Regulations Section 1.59A-3(b)(3)(v)(C); *see also* Proposed Regulations Section 1.59A-1(b)(18), (19).

39 Preamble at 65963.

40 Prior Report at 29-30.

even though such payments may also be treated as deductions from gross income.[41] By contrast, similar amounts incurred by life insurance companies generally would be treated as deductions from gross income.

We believe that treating property and casualty losses as outside of the scope of Base Erosion Payments makes sense both (i) in light of the statutory language of Section 832(b)(3) treating losses as not part of gross income (rather than as a deduction) and (ii) given that the premiums received by an insurance company are inbound payments (and the loss claims are effectively the "product" of the business that is sold in exchange for such premiums). In other words, economically, an insurer exchanges the value of claims payments for premium payments (and investment income from investment of reserves); though the rules for determining the net value derived by the insurer for U.S. federal income tax purposes are complex, the insurer, by virtue of the nature of its business, can only derive economic benefit to the extent that the insurer's gross income exceeds its claims payments, and thus, in such situations, the insurer's activities are accretive to the U.S. tax base.

Whether to eliminate payments for claims (including third-party claims) entirely from the denominator of the Base Erosion Percentage is a more difficult question. In other situations, such as with services payments, it is clear that payments to third parties are deductions. If the analysis were strictly based on the statutory language in Section 832(b)(3), it appears that such loss claims would fall outside of the denominator completely, and that could be a valid position. We note, however, that such treatment would likely provide unintended results, as the (proportionately) smaller deductions that remain may not be representative of the overall insurance business. Thus, where a reinsurer has made claims payments that represent economic losses to the reinsurer, eliminating only related party deductions from both the numerator and the denominator of the Base Erosion Percentage might be justified.[42]

Furthermore, in the Preamble, Treasury requested comments about the distinction between life and non-life insurance businesses. We agree that treating life insurance losses differently from property and casualty losses for purposes of Section 59A makes little sense, and, as a substantive matter, we see little reason to distinguish the businesses. The distinction between them seems to be a quirk of legislative drafting. The fact that Section 801(b) defines "life insurance taxable income" to mean "life insurance gross income, reduced by [] life insurance deductions" is an oddity. However, we acknowledge that Section 801(b) is drafted differently from Section 832(b)(3), and sometimes the Code provides for disparate results.

b) Reinsurance—netting

The Preamble states that Treasury requests comments addressing "whether a distinction should be made between reinsurance contracts entered into by an applicable taxpayer and a foreign related party that provide for settlement of amounts owed on a net basis and other

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41 Preamble at 65968.

42 It is not clear whether reserves should be treated as losses for this purpose. The appropriate treatment may be different with respect to life insurance companies as opposed to property and casualty insurance companies. *See* Section 807(b) (treating increases in life insurance company reserves as giving rise to a deduction).

commercial contracts entered into by an applicable taxpayer and a foreign related party that provide for netting of items payable by one party against items payable by the other party in determining that net amount to be paid between the parties."[43] We note in particular that in many reinsurance transactions, a "ceding commission" is paid by the reinsurer to the reinsured party (*i.e.*, the risk transferor), and such commission is netted against the premium paid by the reinsured party. We believe that this situation is addressed by the discussion of single economic arrangements in Part III.C.5, below, but we acknowledge that these are difficult lines to draw.

5. Netting

Proposed Regulations Section 1.59A-3(b)(2)(ii) provides that in general, "the amount of any base erosion payment is determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis. For this purpose, a right to make or receive payments on a net basis permits the parties to a transaction or series of transactions to settle obligations by offsetting any amounts to be paid by one party against amounts owed by that party to the other party. For example, any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments is not reduced by or netted against other amounts owed to the taxpayer from the foreign related party or by reserve adjustments or other returns."

The Preamble explains that

> The Treasury Department and the IRS are aware that 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. The Treasury Department and the IRS are also aware that other commercial agreements with 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 because the BEAT statutory framework is based on including the gross amount of deductible and certain other payments (base erosion payments) in the BEAT's expanded modified taxable income base without regard to reciprocal obligations or payments that are taken into account in the regular income tax base, but not the BEAT's modified taxable income base. Generally, the amounts of income and deduction are determined on a gross basis under the Code; however, as discussed in Part III of this Explanation of Provisions section, if there are situations where an application of otherwise generally applicable tax law would provide that a deduction is computed on a net basis (because an item received reduces the item of deduction rather than increasing gross income), the proposed regulations do not change that result.[44]

[43] Preamble at 65968.

[44] *Id.*

First, we agree that permitting netting where it is otherwise permitted under the Code and Treasury Regulations is appropriate. However, some clarifying examples may be useful. For example, cost sharing arrangements under 1.482-7 appear to be a situation where netting is permitted,[45] but confirmation may be useful. In addition, "setoffs" of multiple allocations between controlled taxpayers under Section 482 and Treasury Regulations Section 1.482-1(g)(4) appear to warrant similar treatment.

Second, in some circumstances, contractual netting could be treated as giving rise to a single payment. For example, in the case of a fixed-to-floating swap where a single net payment is made by one party, it appears that disaggregating the payment into two amounts is unnecessary, and to do so only where the relevant contractual arrangements are written in a way that explicitly acknowledges two offsetting notional amounts would elevate form over substance.[46] In addition, we note that, if contractual netting is not treated as giving rise to a single payment for purposes of determining the denominator of the Base Erosion Percentage, then disaggregation could cause taxpayers not to be subject to the application of BEAT as a result of transactions with unrelated parties that give rise to payments that largely offset each other as an economic matter but that involve large deductions that, if disaggregated, would increase the denominator of each taxpayer's Base Erosion Percentage. However, we acknowledge that the limits of such contractual netting are difficult to draw. One possibility that we suggest Treasury consider would be to treat netting as giving rise to a single payment where the underlying economic arrangement is that parties to a single economic transaction exchange net value in the form of a single payment (as opposed to engaging in multiple value-for-value exchanges and netting contemporaneous cash payments). It is not clear whether the Proposed Regulations adopt such an approach, and thus we request clarification, possibly by way of examples, regarding situations in which netting is permitted.

6. Global dealing allocations and residual profits splits

The Proposed Regulations do not specifically address whether global dealing allocations would be treated as "payments" to related parties for purposes of Section 59A. The proposed regulations that address global dealing allocations generally provide that amounts of income are allocated to a U.S. trade or business based on a sourcing rule that treats each qualified business unit of the applicable global dealing operation as a participant in the operation.[47] We believe that such allocations are most accurately viewed as allocations of

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45 *See also* Treasury Regulations Section 1.482-7(j)(3)(ii) (addressing the treatment of payments made by controlled participants engaged in "platform contributions transactions" ("A PCT Payor's payment . . . is deemed to be reduced to the extent of any payments owed to it under such paragraph from other controlled participants. Each PCT Payment received by a PCT Payee will be treated as coming pro rata out of payments made by all PCT Payors.")); Treasury Regulations Section 1.482-7(j)(3)(i) (containing similar language with respect to cost-sharing transaction payments).

46 We note that Treasury Regulations Section 1.446-3(d) may be read to permit taxpayers to net payments made with respect to a fixed-to-floating swap for BEAT purposes, but clarification of this point by way of an example would be helpful.

47 *See* Proposed Treasury Regulations Section 1.863-3(h)(3)(i) ("Except as otherwise provided in this paragraph (h), where a single controlled taxpayer conducts a global dealing operation through one or more qualified business units (QBUs) . . . the source of income, gain or loss generated by the global dealing

income for U.S. federal income tax purposes, rather than as payments or accruals by any of the applicable entities among each other, and we request clarification to this effect.[48]

Similarly, allocations that result from the use of the profit split methods under Section 482 and Treasury Regulations Section 1.482-6 should be accorded the same treatment where parties are effectively treated as engaging in a single set of operations. We acknowledge that, in some cases, a profit split method may be used to determine the amount of a deductible payment (such as where a foreign related party licenses intellectual property to a U.S. party, and the profit split method is used to determine the amount of the royalty). Other cases, however, may be more similar to the global dealing example, in which case similar treatment would be warranted.

7. Interest expense allocable to ECI

The Prior Report discussed the applicability of BEAT to the interest expense of a U.S. branch (or other activity related to ECI). In the Prior Report, we recommended that (1) regardless of whether the taxpayer uses the "adjusted U.S. booked liabilities" ("***AUSBL***") method or the "separate currency pools" method, interest expense on U.S.-booked liabilities ("***Branch Interest***") should be treated as paid to the branch's creditor for purposes of BEAT, and (2) the excess amount of a foreign corporation's interest allocated or apportioned to ECI under Treasury Regulations Section 1.882-5 over Branch Interest (such excess amount, "***Excess Interest***") should also be subject to BEAT to the extent that the foreign corporation has borrowed from a foreign related party.[49]

The Proposed Regulations generally provide that a foreign corporation that has interest expense allocable under Section 882(c) to ECI is treated as making a Base Erosion Payment to the extent that such interest expense results from a payment or accrual to a foreign

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operation and earned by or allocated to the controlled taxpayer shall be determined by applying the rules of § 1.482-8 as if each QBU that performs activities of a regular dealer in securities . . . or the related activities described in §1.482-8(a)(2)(ii)(B) were a separate controlled taxpayer qualifying as a participant in the global dealing operation within the meaning of § 1.482-8(a)(2)(ii)."); *see also, e.g.*, Proposed Treasury Regulations Section 1.864-4(c)(5)(vi)(*a*) ("U.S. source interest, including substitute interest as defined in § 1.861-2(a)(7), and dividend income, including substitute dividends as defined in § 1.861-3(a)(6), derived by a participant in a global dealing operation, as defined in § 1.482-8(a)(2)(i), shall be treated as attributable to the foreign corporation's U.S. trade or business, only if and to the extent that the income would be treated as U.S. source if § 1.863-3(h) were to apply to such amounts.").

48 Further support for our view stems from the rule that such allocations can give rise to nondeductible deemed distributions or capital contributions between related parties, suggesting that the allocation itself is not a deemed payment that should be subject to Section 59A. *See* Treasury Regulations Section 1.482-1(g)(3)(i) ("Appropriate adjustments must be made to conform a taxpayer's accounts to reflect allocations made under section 482. Such adjustments may include the treatment of an allocated amount as a dividend or a capital contribution (as appropriate).").

49 The Prior Report acknowledged that a literal reading of Section 59A(d) suggests that BEAT is inapplicable to Excess Interest, since the deduction for Excess Interest is notional and does not itself represent a payment or accrual to any person. *See* Prior Report at 27. The Prior Report, however, also recognizes that such a literal reading is not the only acceptable reading, given that Excess Interest is treated under the Treasury Regulations as an allocation or apportionment to ECI of a portion of the foreign corporation's third-party interest expense. *Id*.

related party.[50] We note, however, that there are several inconsistencies in the Proposed Regulations with respect to the allocation of interest expense to ECI.

a) Treaty allocations to a branch and excess interest

The treatment under the Proposed Regulations of interest expense allocable to ECI pursuant to the business profits provisions of an income tax treaty is inconsistent with the treatment under the Proposed Regulations of interest expense allocable to ECI under Treasury Regulations Section 1.882-5.

More specifically, where a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed and functions performed by the permanent establishment, the Proposed Regulations treat transactions between the permanent establishment and the home office or other branches of the foreign corporation (such transactions, "***Internal Dealings***") as being actually paid or accrued for purposes of determining whether there is a Base Erosion Payment.[51] Under Treasury Regulations Section 1.882-5(c)(2)(viii), on the other hand, transactions between separate offices or branches of the same taxpayer are ignored, and the allocation of interest expense for purposes of determining Base Erosion Payments is dependent on the foreign corporation's worldwide borrowings from related foreign parties.

The Preamble explains that the allocation of interest expense under Treasury Regulations Section 1.882-5 is distinct from Internal Dealings, because the former "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," while Internal Dealings "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."[52]

We note that the arm's-length construct described above for characterizing Internal Dealings pursuant to an income tax treaty represents an attempt to fairly apportion the operating results of the U.S. permanent establishment and the home office or other branches of the foreign corporation. This goal is similar to the goal of the allocation rules under Treasury Regulations Section 1.882-5. By drawing a distinction between Internal Dealings and allocations pursuant to Treasury Regulations Section 1.882-5, the Proposed Regulations create a regime that could be more taxpayer-adverse under a treaty as compared with U.S. law in the absence of a treaty.[53] Treasury should consider this approach in light of treaty non-discrimination provisions and, in the case of a taxpayer applying both Internal Dealings and allocations under Treasury

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[50] Proposed Regulations Section 1.59A-3(b)(4).

[51] Proposed Regulations Section 1.59A-3(b)(4)(v).

[52] Preamble at 65961.

[53] We acknowledge that the distinction drawn by the Proposed Regulations is arguably supported by the reasoning in *Nat'l Westminster Bank, PLC* v. *United States*, 512 F.3d 1347 (Fed. Cir. 2008), which interpreted the business profits provisions of the 1975 U.S.-U.K. income tax treaty as not "permitting transactions between the permanent establishment and the enterprise to be disregarded" and thus interpreted the treaty as taking a different approach from Treasury Regulations Section 1.882-5. *Id.* at 1354-55, 1359.

Regulations Section 1.882-5 for different businesses in the same year, in light of treaty consistency principles.[54]

b) AUSBL method and separate currency pools method

The Proposed Regulations create a discrepancy between taxpayers that use the AUSBL method and taxpayers that use the separate currency pools method. The Proposed Regulations provide that for taxpayers that use the AUSBL method, the amount of interest expense that constitutes a Base Erosion Payment is equal to the sum of (1) "direct allocations" of interest expense or interest expense on U.S.-booked liabilities that is paid or accrued to a foreign related party and (2) interest expense on U.S.-connected liabilities in excess of U.S.-booked liabilities ("***Excess U.S.-Connected Liabilities***") multiplied by a fraction representing the percentage of the taxpayer's worldwide liabilities that is owed to a foreign related party.[55]

The Proposed Regulations provide that for taxpayers that use the separate currency pools method, the amount of interest expense that constitutes a Base Erosion Payment is equal to the sum of (1) "direct allocations" of interest expense paid or accrued to a foreign related party and (2) the interest expense in each currency pool multiplied by a fraction representing the percentage of the taxpayer's worldwide liabilities that is owed to a foreign related party for that currency pool.[56]

Thus, under the AUSBL method, only the portion of interest expense on Excess U.S.-Connected Liabilities is multiplied by a fraction, whereas under the separate currency pools method, the entire amount of interest expense in each currency pool is multiplied by a fraction. We acknowledge that this discrepancy is in part a consequence of the distinctions between the methodologies underlying the AUSBL method and the separate currency pools method, but we request clarification regarding whether Treasury believes the discrepancy is justified in the context of Section 59A.

c) Simplifying elections for determining the portion of U.S.-connected liabilities that are paid to a foreign related party

The Preamble notes that certain simplifying elections are available under Treasury Regulations Section 1.882-5 for determining the amount of interest incurred by a foreign corporation that is deductible and requests comments regarding similar simplifying elections for determining the portion of U.S.-connected liabilities that are paid to a foreign related party. It may be appropriate for final regulations to include a rule that permits taxpayers to elect to determine the portion of U.S.-connected liabilities that are paid to foreign related parties based on the ratio of the foreign corporation's liabilities that are owed to foreign related parties to the foreign corporation's total liabilities.

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[54] *See* Revenue Ruling 84-17, 1984-1 C. B. 308; *see also* New York State Bar Association Tax Section Report No. 1325, Tax Treaty Consistency Principle (July 14, 2015).

[55] Proposed Regulations Section 1.59A-3(b)(4)(i)(A).

[56] Proposed Regulations Section 1.59A-3(b)(4)(i)(B).

8. Branch interest withholding

Consistent with the language of Section 59A,[57] the Proposed Regulations provide that if tax is imposed under Section 871 or 881 on a Base Erosion Payment, and the tax is withheld under Section 1441 or 1442, then the Base Erosion Payment is not taken into account as a Base Erosion Tax Benefit.[58] The exclusion from treatment as a Base Erosion Tax Benefit is reduced ratably (*i.e.*, payments do give rise to Base Erosion Tax Benefits) if the applicable tax imposed by Section 871 or 881 is reduced by an income tax treaty.[59]

The Treasury Regulations under Section 884 provide that the Excess Interest of a foreign corporation with a U.S. branch is subject to tax under Section 881(a) in the same manner as if such Excess Interest were interest paid to the foreign corporation by a wholly owned domestic corporation.[60] Accordingly, we believe that the exclusion for payments subject to full withholding under the Proposed Regulations should be interpreted to apply to any Excess Interest subject to full withholding under Section 884. To avoid any ambiguities, however, we suggest that final regulations expressly provide that the exclusion for payments subject to withholding applies to any Excess Interest subject to withholding under Section 884 and the Treasury Regulations thereunder.

9. Subpart F income and GILTI

In the Prior Report, we recommended that where a payment by a U.S. corporate taxpayer is made to a controlled foreign corporation ("***CFC***") of such taxpayer, and the payment results in a current inclusion to the taxpayer of either Subpart F income or global intangible low tax income ("***GILTI***") by a U.S. shareholder under Section 951A, such payment should not be treated as a Base Erosion Payment. Such a rule is necessary because a taxpayer could be a U.S. shareholder of a CFC even though the CFC and the taxpayer are not included in the same Aggregate Group, such that a payment by the U.S. shareholder to the CFC could give rise to a Subpart F or GILTI inclusion while also being treated as a Base Erosion Payment made by the U.S. shareholder. More broadly, payments that give rise to a Subpart F or GILTI inclusion are analogous to payments that give rise to ECI in that such payments do not erode the U.S. tax base.[61] The Preamble and the Proposed Regulations do not address this issue, and we again recommend that an exception be made for amounts that will otherwise be subject to tax in the U.S.

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57 Section 59A(c)(2)(B).

58 Proposed Regulations Section 1.59A-3(c)(2).

59 Proposed Regulations Section 1.59A-3(c)(3).

60 Treasury Regulations Section 1.884-4(a)(2)(ii).

61 *Cf.* REG-104352-18, Federal Register Vol. 83, No. 248, December 28, 2018 at 67628 (proposing to exclude payments that are included in GILTI from disallowance under Section 267A(a), because such payments "do not give rise to a [deduction/no-inclusion] outcome and, therefore, it is consistent with the policy of section 267A and the grant of authority in section 267A(e) to exempt them from disallowance under section 267A.").

We acknowledge that any exception along the lines discussed above may include certain limitations and exceptions. In considering such limitations and exceptions, it may be illustrative to discuss several alternative cases involving Subpart F income or GILTI.

First, in a case where a payment by a U.S. corporate taxpayer results in a CFC recognizing Subpart F income without any offsetting foreign tax credits arising from the payment, we maintain the position put forth in the Prior Report that it would be reasonable to allow taxpayers to exclude such a payment from Base Erosion Payments and Base Erosion Tax Benefits calculations to the extent of the taxpayer's current year inclusion of such Subpart F income. As explained in the Prior Report, this may require the taxpayer to identify the recipient CFC and the amount of payment excluded from Base Erosion Payments and included in income.[62]

Similarly, in the case where a payment by a U.S. corporate taxpayer results in the current year inclusion of GILTI without any offsetting foreign tax credit, we maintain our recommendation in the Prior Report that it would be reasonable to allow the taxpayer to exclude such a payment from Base Erosion payments and Base Erosion Tax Benefits calculations to the extent of such current year inclusion of GILTI. We acknowledge, however, that an exclusion for GILTI raises several additional considerations compared to an exclusion for Subpart F income. One such consideration is that, unlike Subpart F income, the amount of GILTI is determined at the shareholder level through the aggregation of the shareholder's pro rata share of CFC-level items such as each CFC's "tested loss" or "tested income."[63] As a result, it may be difficult to attribute GILTI inclusions to particular payments to a CFC, when, for example, the same payment may result in different GILTI inclusions in different years. Thus, it may be appropriate for final regulations to provide that an exclusion for certain payments as discussed above is only available if the payee CFC specifically reports the amount of income that is attributable to such payments and the amount of the inclusions of the applicable U.S. shareholders that is attributable to such income. Another complication arises because GILTI is generally subject to a deduction under Section 250 with respect to certain taxpayers. We maintain our recommendation in the Prior Report that any exception for payments giving rise to GILTI that applies at the U.S. shareholder level should be reduced to the U.S. shareholder's net effective inclusion (*i.e.*, net of the Section 250 deduction).

Third, in the case where foreign tax credits are available to offset current year inclusions of Subpart F income or GILTI that arose as a result of a U.S. person's payment to a CFC, we stated in the Prior Report that no adjustment should be necessary for foreign tax credits associated with such income, because the Subpart F income or GILTI inclusion are included in the Modified Taxable Income of the U.S. shareholder of the CFC and the BEAT is computed without regard to foreign tax credits. In other words, the income will be included properly for BEAT purposes in the hands of the U.S. shareholder of the CFC, and any foreign tax credits

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[62] *See* Prior Report at 19.

[63] The amount of GILTI to be included in a U.S. shareholder's income equals the excess of the U.S. shareholder's "net CFC tested income" over its "net deemed tangible income return," each of which is an aggregate measure of the U.S. shareholder's pro rata share of items determined at the CFC level.

associated with that income should be subject to the same treatment for purposes of computing Modified Taxable Income as any other tax credits of the U.S. shareholder.

10. Payments resulting in recognized losses

The Preamble states that "a payment to a foreign related party resulting in a recognized loss" is a Base Erosion Payment, including, for example, "a loss recognized on the transfer of property to a foreign related party."[64]

We acknowledge that treating any loss recognized in connection with a payment to a foreign related party as giving rise to a Base Erosion Payment is conceptually consistent with the treatment of other payments as Base Erosion Payments to the extent that such payments represent a deductible amount to the taxpayer. However, we believe that where a taxpayer has suffered an economic loss with respect to property, that loss should not be subject to Section 59A. If the loss has been suffered, it does not appear to matter to whom the asset is transferred. Section 267 may defer the loss for related parties, and we believe that that is sufficient protection.[65]

In addition, we note that because a seller's amount realized with respect to a disposition of property is already governed by general tax principles, including Section 482, the amount of a recognized loss should be presumed to be bona fide. Because the cash or property received by the taxpayer in exchange for the property thus has value and income-producing potential commensurate with the property disposed of, it is not clear that such dispositions of property should be treated as giving rise to Base Erosion Payments. Elsewhere in the Preamble and the Proposed Regulations, as well as under Section 59A, it is the movement of depreciable property <u>into</u> the U.S. tax base that is treated as giving rise to potential base erosion; the recognition of a bona fide loss in connection with the transfer of such property <u>out</u> of the U.S. tax base does not necessarily warrant the same treatment.

From a statutory perspective, the "payment" in this case must be the loss property, and the acquired asset or service or other benefit is cash. Such a characterization seems in tension with the statute. Furthermore, even if the property is payment, in order for a transfer of property to constitute a Base Erosion Payment under Section 59A(d)(1), the transfer of such property must be an "amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable." Even though a recognized loss may represent an amount of loss being "accrued" by a taxpayer, it is not clear to us that such amount is accrued "to a foreign person," because the only value transferred to a foreign person is the value of the property at the time of the transfer (*i.e.*, after the taxpayer's loss has been taken into account). In other words, it is not clear to us that the loss is "with respect to" the "amount paid or accrued," as the amount paid or accrued is arguably the value of the property

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[64] Preamble at 65960.

[65] We acknowledge that it is possible for parties to be related to each other for purposes of Section 59A but not for purposes of Section 267, such that a loss could be immediately recognized in connection with a transfer of property to a party that is related to the seller for purposes of Section 59A. However, under such circumstances, the parties to the transaction do not have a sufficiently close relationship to cause the loss to be deferred for non-BEAT purposes.

transferred and the loss is the excess of the taxpayer's basis over such amount. This standard is in contrast to the statutory rule that governs the amounts that may be included in the denominator of the Base Erosion Percentage, because such amounts may include "the aggregate amount of the deductions . . . allowable to the taxpayer" for the taxable year.[66]

We do appreciate a counterargument, though, to our view that recognized losses on sales to foreign related parties should not be within the ambit of Section 59A. Despite the application of Section 482, the amount realized on such a sale could be viewed as artificial as it is set by related parties. Thus, the amount of the loss suffered by the seller could be viewed as questionable in some circumstances. For example, suppose the seller has a basis of $100 in an asset, which it sells to a foreign related person for $80, recognizing a $20 loss (which may be deferred under Section 267). Suppose the foreign related person sells the asset for $100. A question could be raised as to whether the value of $80 ascribed to the asset by the related parties was correct. Section 482 monitors this issue, but one could argue that it is also the province of Section 59A.

To the extent that final regulations include a rule treating losses as a Base Erosion Payment, it may be helpful for the final regulations to include illustrative examples and to clarify that a loss recognized on the transfer of property to a foreign related party only gives rise to a Base Erosion Payment if the loss is utilized by the taxpayer (such that, for example, a loss that is deferred pursuant to Section 267(f)(2) does not give rise to a Base Erosion Payment while the loss is deferred). In addition, the Proposed Regulations should clarify to what extent a taxpayer is treated as recognizing losses that give rise to Base Erosion Payments where the taxpayer recognizes losses on transfers of property both to foreign related parties and to parties that are not foreign related parties, but the taxpayer's overall deduction for losses is subject to limitation under another provision of the Code (for example, the limitation on capital losses of a corporation under Section 1211(a)). The treatment in Proposed Regulations Section 1.59A-3(c)(4)(ii)(B) of interest deductions that are not limited by Section 163(j) may suggest how to order the relevant deductions for losses in the aforementioned situation.

11. Mark-to-market transactions

Proposed Regulations Section 1.59A-3(b)(2)(iii) states that "[f]or any transaction with respect to which the taxpayer applies the mark-to-market method of accounting for federal income tax purposes," the Mark-to-Market Rule "applies to determine the amount of base erosion payment." This language might be read to suggest that mark-to-market losses may be treated as Base Erosion Payments. The only category of Base Erosion Payment that is potentially relevant in the case of mark-to-market losses is that applicable to deductible amounts paid or accrued by the taxpayer to a foreign related party. However, a mark-to-market loss is treated under Section 475 as arising from a deemed sale or other disposition of the relevant security to an "unrelated person."[67] Because a mark-to-market loss is treated as arising from a

66 Section 59A(c)(4)(A)(ii)(I).

67 Com. Rep. No. 103-66 (Aug. 10, 1993) ("For purposes of [Section 475], a security is treated as sold to a person that is not related to the dealer even if the security is itself a contract between the dealer and a related person.")

sale to an unrelated person, it is not clear why Proposed Regulations Section 1.59A-3(b)(2)(iii) would cross-reference the Mark-to-Market Rule in determining the amount of Base Erosion Payments, unless Treasury's intention is to treat an amount that otherwise would not be considered a Base Erosion Payment under the general definition of that term to be considered a Base Erosion Payment simply by virtue of the fact that the amount was derived from a transaction that is marked to market. It is not apparent from a policy perspective why that would be the case. Further, as described in Part III.C.10 above, we are recommending that a loss recognized on an actual sale of property to a foreign related party not be considered a Base Erosion Payment; mark-to-market losses generally should be treated in the same manner as losses on actual sales of property for this purpose, such that we recommend that a mark-to-market loss should not be treated as a Base Erosion Payment even if the loss were treated as arising from a sale to a foreign related party.

We also note that most transactions giving rise to mark-to-market losses would not result in Base Erosion Payments, because such transactions are either (i) derivatives eligible for the exclusion from Base Erosion Payment treatment for "qualified derivative payments" as defined in Section 59A(h)(2) (a "***Qualified Derivative Payment***") or (ii) the ownership of physical securities (such that changes in value giving rise to mark-to-market losses generally do not involve related counterparties). Under the Proposed Regulations as drafted, the one category of related party transactions that could give rise to mark-to-market losses not eligible for the Qualified Derivative Payment exclusion is securities lending transactions. For the reasons discussed in Part III.F.1, below, we recommend that securities lending transactions generally be considered derivatives eligible for the Qualified Derivative Payment exclusion, in which case deductions (including mark-to-market losses) arising from such transactions would not be treated as Base Erosion Payments. In this regard, it would seem inappropriate for mark-to-market losses on securities lending transactions to give rise to Base Erosion Payments when mark-to-market losses on holding the underlying physical securities do not give rise to Base Erosion Payments.

For the reasons set forth above, we recommend that the rule in Proposed Regulations Section 1.59A-3(b)(2)(iii) be withdrawn. If Proposed Regulations Section 1.59A-3(b)(2)(iii) is not withdrawn, we recommend that the government explain how that rule coordinates with the general treatment of mark-to-market losses as being recognized in transactions with unrelated parties.

D. Proposed Regulations Section 1.59A-4

1. Modified taxable income

Section 59A(c) defines "modified taxable income" ("***Modified Taxable Income***") to be the taxable income of the taxpayer computed under Chapter 1 of the Code but "determined without regard to" (i) any base erosion tax benefit with respect to any Base Erosion Payment and (ii) the Base Erosion Percentage of any net operating loss ("***NOL***") deduction allowed under Section 172 for the taxable year ((i) and (ii), collectively, the "***BEAT Deductions***"). As explained in the Prior Report, there are generally two possible approaches to interpreting the requirement that Modified Taxable Income be determined "without regard to" the BEAT Deductions: the BEAT Deductions could merely be added back to taxable income or taxable income could be recalculated as though the BEAT Deductions did not exist . In defining

Modified Taxable Income, Proposed Regulations Section 1.59A-4 provides that the relevant computation is performed on an add-back basis, rather than on a recomputation basis. The Preamble welcomes comments on the approach adopted by the Proposed Regulations and the practical effects of a recomputation-based approach.[68]

We set forth our views on this subject in detail in the Prior Report, and accordingly we suggest that Treasury consider the relevant discussion on pages 35–40 of the Prior Report. In addition, regardless of the approach that is adopted in final regulations, we believe that it would be helpful for Treasury to provide a more detailed explanation of its decision.

2. Pre-2018 disallowed interest

The Proposed Regulations provide that business interest expense that is not allowed as a deduction under Section 163(j)(1), and that resulted from a payment or accrual to a foreign related party that is carried forward from a taxable year beginning before January 1, 2018, is not a Base Erosion Payment.[69] The Preamble notes that this treatment is consistent with excluding interest paid or accrued before January 1, 2018 from treatment as a Base Erosion Payment.[70] We agree with this conclusion, which is consistent with our view as described in the Prior Report.[71]

3. Vintage-year approach to NOLs

The Proposed Regulations provide that for purposes of adding the Base Erosion Percentage of any NOL deduction back to taxable income in order to compute Modified Taxable Income, the appropriate Base Erosion Percentage to use is that of the year in which the NOL arose (the "***Vintage Year***"),[72] rather than the year in which the NOL is utilized. The Preamble explains that the Vintage Year approach is appropriate because the Base Erosion Percentage from the Vintage Year reflects the amount of the NOL that was composed of Base Erosion Payments. In addition, the Preamble notes that because the vintage year Base Erosion Percentage is a fixed percentage, taxpayers will have greater certainty with respect to the amount of an NOL that will be added back in years after the NOL arises. As we explained in the Prior Report, we agree that the Vintage Year approach is appropriate.[73]

We note that because the relevant Base Erosion Percentage in the Vintage Year is the Base Erosion Percentage for the Aggregate Group that is used to determine whether the taxpayer is an Applicable Taxpayer (rather than a separate determination of the Base Erosion

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68 Preamble at 65965.

69 Proposed Regulations Section 1.59A-3(b)(3)(vii).

70 Preamble at 65964.

71 Prior Report at 43-44.

72 Proposed Regulations Section 1.59A-4(b)(2)(ii).

73 Prior Report at 40-41.

Percentage computed solely by reference to the single taxpayer or its consolidated group),[74] it is possible that the Base Erosion Percentage that is used could take into account deductions of U.S. branches of foreign corporations that are not otherwise included in a taxpayer's return (for example, in the case of a U.S. corporation that is under common control with a foreign corporation that has a U.S. branch). It thus could be the case that a branch incurred significant losses in the Vintage Year even though the relevant U.S. corporation did not incur significant losses in the Vintage Year, such that the Aggregate Group's Vintage Year Base Erosion Percentage could be lower than the U.S. corporation's own Vintage Year Base Erosion Percentage would have been. Although Treasury's approach to this question is mechanically straightforward, we question whether a more precise determination of the taxpayer's Vintage Year Base Erosion Percentage may be appropriate.

E. Proposed Regulations Section 1.59A-5

1. Application of Section 15

Section 59A(b)(1) provides that, with certain exceptions, the "base erosion minimum tax amount" with respect to an applicable taxpayer for any taxable year is the excess of (A) an amount equal to "10 percent (5 percent in the case of taxable years beginning in calendar year 2018)" (which this discussion refers to as the "***BEAT Tax Rate***")[75] of the modified taxable income of such taxpayer for the taxable year over (B) the regular tax liability of the taxpayer for the taxable year, with certain reductions for tax credits.

In the case of an Applicable Taxpayer with a calendar taxable year, the BEAT Tax Rate would clearly be 5% for the first full year, both under the statute and the Proposed Regulations. This is because the Applicable Taxpayer's taxable year "beginning in calendar year 2018" starts on January 1, 2018 and would be the first year it is potentially subject to BEAT, with the BEAT Tax Rate being 5%. For taxable years thereafter, the rate would be 10% (until the BEAT Tax Rate increases to 12.5% for the Applicable Taxpayer's taxable year beginning January 1, 2026[76]). However, with respect to the taxable year "beginning in calendar year 2018" of an Applicable Taxpayer with a fiscal, rather than a calendar, taxable year, Proposed Regulations Section 1.59A-5 takes the position that Section 15 applies such that the Applicable Taxpayer will have a blended BEAT Tax Rate. Specifically, Proposed Regulations Section 1.59A-5(c)(1) provides that the BEAT Tax Rate is (i) 5% for taxable years "beginning in calendar year 2018," and (ii) 10% for taxable years beginning after December 31, 2018 through taxable years beginning before January 1, 2026. Proposed Regulations Section 1.59A-5(c)(3) then provides that, while Section 15 does not apply to any taxable year that includes January 1,

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[74] Preamble at 65966.

[75] Section 59A(b)(3) provides that, in the case of taxpayer that is a member of an affiliated group that includes either a bank (as defined in Section 581) or a registered securities dealer under section 15(a) of the Securities Exchange Act of 1934, the rates of tax specified in Section 59A(b)(1)(A) and (2) are increased by one percentage point. For ease of discussion, this section uses the BEAT Tax Rates specified in Section 59A(b)(1) and (2), although the discussion herein applies equally to the BEAT Tax Rates that apply to taxpayers to which the BEAT Tax Rates specified in Section 59A(b)(3) apply.

[76] *See* Section 59A(b)(2).

2018, "[f]or a taxpayer using a taxable year other than the calendar year," Section 15 applies to any taxable year beginning after January 1, 2018.

Section 15(a) provides that "[i]f any rate of tax imposed by [Chapter 1 of the Code] changes, and if the taxable year includes the effective date of the change (unless that date is the first day of the taxable year)," then (i) tentative taxes are computed by applying the rate for the period before the effective date of the change and the rate for the period on and after that date, to the taxable income for the entire taxable year; and (ii) the tax for such taxable year is the sum of the proportion of each tentative tax which the number of days in each period bears to the number of days in the entire taxable year. Put more simply, if Section 15(a) applies, then a taxpayer's tax for the taxable year in which a rate of tax changes during the middle of the year is determined using a blended rate of tax that is based on the number of days in the taxable year before and after the change. Section 15(c) provides rules for determining the "effective date" of the change in the rate of tax:

> For purposes of subsections (a) and (b) –
>
> (1) if the rate changes for taxable years "beginning after" or "ending after" a certain date, the following day shall be considered the effective date of the change; and
>
> (2) if a rate changes for taxable years "beginning on or after" a certain date, that date shall be considered the effective date of the change.

The statement in Proposed Regulations Section 1.59A-5(c)(3) that for a taxpayer using a fiscal year, "section 15 applies to any taxable year beginning after January 1, 2018" appears to be premised on two subsidiary conclusions: (1) there is a change in the BEAT Tax Rate (from 5% to 10%) and (2) the effective date of this change is January 1, 2019. Although (1) is indisputably correct, we question whether (2) is correct. Rather, the statutory language of Section 59A(b)(1)(A)—"5 percent in the case of taxable years beginning in calendar year 2018—implies that the 5% BEAT Tax Rate applies for the <u>entirety</u> of a fiscal taxpayer's taxable year that begins in calendar year 2018. Note that rather than specifying an increase in the BEAT Tax rate, the statute sets the rate at 10% and then carves out a 5% rate for taxable years beginning in 2018.[77] The most natural reading of Section 59A(b)(1)(A) is that Section 15 does not apply at all (and does not need to apply) with respect to any taxpayer, as there is no "effective date," within the meaning of Section 15, of the change in the BEAT Tax Rate: Section 59A(b)(1)(A) prescribes a 5% rate for a specified taxable year, and does not anywhere refer to a "certain date" that can be properly characterized as an "effective date" for purposes of Section 15. Alternatively, one could read Section 59A(b)(1)(A) as providing that the "effective date" of

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[77] Note that the BEAT first becomes applicable for tax years beginning in 2018. So if the date of the rate change is considered to be January 1, 2019, then for a fiscal year taxpayer, the rate change is occurring within the same taxable year that the taxpayer becomes subject to the BEAT. Treasury Regulations Section 1.15-1(d) provides that "If the effective date of the imposition of a new tax and the effective date of a change in rate of such tax fall in the same taxable year, section [15] is not applicable in computing the taxpayer's liability for such tax for such year unless the new tax is expressly imposed upon the taxpayer for a portion of his taxable year prior to the change in rate."

the change in the BEAT Tax Rate to 10% with respect to any given taxpayer is the first day of that taxpayer's taxable year that begins in calendar year 2019 (*i.e.*, the first day of its taxable year that begins after the end of its taxable year date that begins in calendar year 2018).[78] But the result under either interpretation is that the BEAT Tax Rate for a fiscal year taxpayer for its taxable year that begins in calendar year 2018 is 5% for the entire taxable year, and Treasury should so provide in final regulations.

Section 15 itself supports this conclusion. As noted above, Congress provided specific rules for determining the effective date of a change in tax rates in Section 15(c) in a case where a change in a tax rate was to be effective for particular taxable years. Those rules appear to apply only if the relevant statutory language that implements the change contains the precise language set off in quotation marks in Section 15(c)(1) and (2)—"beginning after," "ending after," or "beginning on or after"—in reference to a "certain date." Section 59A(b)(1)(A) does not use any of this language (it uses the phrase "beginning in calendar year 2018"), and it does not refer to a "certain date" (it refers to "calendar year 2018"), for the change in the BEAT Tax Rate from 5% to 10%. If Congress had intended for Section 15 to apply to the change in the BEAT Tax Rate from 5% to 10%, it could have used the prescribed form of words in Section 15(c). Congress did not do so.

It is important to note that, elsewhere in the TCJA, Congress did in fact use the prescribed form of language to bring Section 15 into play in other provisions in which it changed a rate of tax—even within the BEAT itself. For example, section 13001(a) of the TCJA amended Section 11(b) to change the rates of federal corporate income tax imposed by Section 11(a) from the pre-TCJA rates to 21%. Section 13001(c)(1) provides generally that "the amendment[ ] made by [section 13001(a)] shall apply to taxable years beginning after December 31, 2017." This is the form of words—using the phrase "beginning after" and specifying a "certain date"—prescribed by Section 15(c), such that Section 15(a) applies, as the IRS has properly recognized.[79] Even more directly relevant, Section 59A(b)(2) provides for an increase in the BEAT Tax Rate from 10% to 12.5% "[i]n the case of any taxable year beginning after December 31, 2025." Again, this is the form of words to which Section 15(c), and thus Section 15(a), apply. The fact that Congress, even within the BEAT itself, used the specific language prescribed in Section 15(c), but pointedly did not do so in Section 59A(b)(1)(A), suggests that Congress did not intend Section 15 to apply for purposes of the change in the BEAT Tax Rate from 5% to 10%.

Finally, the legislative history to Section 59A arguably supports the view that Section 15 does not apply to the change in the BEAT Tax Rate from 5% to 10%. In the text of the Conference Report, the conferees refer to the 10% BEAT Tax Rate, and then in a footnote state that "[a] 5 percent rate applies for one year for base erosion payments paid or accrued in taxable years beginning after December 31, 2017." The footnote's reference to "for one year" supports the view that a blended Section 15 rate was not intended. It is arguable, on the other

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[78] Section 14401(e) of the TCJA provides in relevant part that section 59A applies "to base erosion payments . . . paid or accrued in taxable years beginning after December 31, 2017." As this provision does not address the effective date of the change in the BEAT tax rate, it is not directly relevant to the analysis.

[79] *See* Notice 2018-38, 2018-18 I.R.B. 522.

hand, that the reference to "one year" was a statement of the general impact, true for calendar year taxpayers, and not necessarily meant to capture the impact for all taxpayers, but that reading would in turn raise the question what "taxable years" the footnote refers to (i.e., why was the plural "years" used if only the calendar year was meant to be referred to?). It is also arguably notable that the footnote, unlike the statute, uses the language prescribed in Section 15(c)—"taxable years beginning after December 31, 2017"—but this is arguably not significant as December 31, 2017 is not a relevant date for the change in BEAT Tax Rate from 5% to 10%.

We acknowledge that the distinction drawn between the language used in Section 59A and the language set off in quotation marks in Section 15 is arguably formalistic, and we do not rule out the possibility that Section 15(a) could apply in the case of a change in the rate of tax with respect to which Congress specified an effective date, in relation to a taxable year, that did not use the precise form of words specified in Section 15(c). However, in this case, the fact that Congress did not use in Section 59A(b)(1)(A) the precise form of words specified in Section 15(c) (despite using the precise language later in the same Code section), and the statement in the legislative history cause us to believe that Treasury should not try to bring Section 59A(b)(1)(A) within the scope of Section 15—in essence, by rewriting Section 59A(b)(1)(A) to include both the prescribed form of words in Section 15(c) and to refer to a specific date (*e.g.*, "5 percent in the case of taxable years beginning on or after January 1, 2018")—as opposed to simply giving effect to the words that Congress wrote in Section 59A(b)(1)(A).

F. Proposed Regulations Section 1.59A-6

1. Qualified derivative payments

Proposed Regulations Section 1.59A-3(b)(3)(ii) provides that the term Base Erosion Payment generally excludes any "qualified derivative payment" as defined in Section 59A(h)(2) (a "***Qualified Derivative Payment***").[80] Proposed Regulations Section 1.59A-6(b)(1) defines a Qualified Derivative Payment to be a payment made by a taxpayer to a foreign related party pursuant to a derivative with respect to which the taxpayer recognizes gain or loss as if the derivative were sold for its fair market value on the last business day of the taxable year (and any additional times as required by the Code or the taxpayer's method of accounting); treats any gain or loss so recognized as ordinary; and treats the character of all items of income, deduction, gain or loss with respect to a payment pursuant to the derivative as ordinary. Proposed Regulations Section 1.59A-6(d) defines "derivative" for this purpose and contains an exception whereby "a derivative contract does not include any securities lending transaction, sale-repurchase transaction, or substantially similar transaction."[81] The Preamble explains that any payment that would be treated as a Base Erosion Payment if it were not made pursuant to a derivative, such as a payment of interest on a debt instrument, is explicitly excluded from Qualified Derivative Payment status under Section 59A(h)(3) and (4).

For the reasons discussed below, we believe that (i) repurchase premium and rebate interest amounts paid with respect to securities lending transactions and sale-repurchase

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80 Proposed Regulations Section 1.59A-3(b)(3)(ii).

81 Proposed Regulations Section 1.59A-6(d)(2)(iii).

transactions (also known as "repos") should be excluded from the definition of Qualified Derivative Payment and (ii) securities loans should be treated as "derivatives" for purposes of Section 59A that accordingly may give rise to Qualified Derivative Payments.

For example, consider a transaction in which a taxpayer owns a security and either enters into a repo transaction to sell and repurchase the security or otherwise simply lends the security to another person. The taxpayer receives either a cash purchase price (in the case of the repo) or cash collateral (in the case of the security loan), and the taxpayer pays either repurchase premium (in the case of the repo) or rebate on the cash amount (in the case of the security loan), both of which amounts should be treated as interest for tax purposes. In either case, it seems that regardless of whether the transaction is a "derivative," the payments treated as interest should not be Qualified Derivative Payments, by application of Section 59A(h)(3)(A) (*i.e.*, a payment, including interest, that would be treated as a Base Erosion Payment if it were not made pursuant to a derivative). To this extent, the statement in the Preamble that "sale-repurchase transactions and securities lending transactions are economically similar to each other" is accurate as a policy matter and as a technical matter. As we believe these interest payments are not Qualified Derivative Payments under the statutory language, we believe that the Proposed Regulations should clarify that Section 59A(h)(3)(A) applies to prevent the Qualified Derivative Payment exclusion from applying to interest on a repo or cash collateral posted in respect of a securities loan.

The rule in the Proposed Regulations providing that securities lending and sale-repurchase transactions are not derivatives for purposes of section 59A has, however, created uncertainty about whether substitute payments that arise in connection with those transactions will be treated as Qualified Derivative Payments. Where the taxpayer either purchases and resells a security in a repo transaction or borrows a security from another person, payments made by the taxpayer may include substitute payments with respect to the underlying security and possibly fees for borrowing the security. In these cases, the appropriate treatment for repos and for transactions treated as securities loans may be different from one another.

If the transaction is a repo that is treated as debt held by the taxpayer for tax purposes, then the "substitute payment" is actually not a substitute payment—it is just a transfer to the seller of the security of an amount that is considered income earned directly by the seller for tax purposes (because the seller is viewed for tax purposes as continuing to own the security). In principle, the purchaser in such a repo transaction should have no income when the purchaser receives the distribution on the underlying security and no deduction when the purchaser transfers that amount to the seller, such that the amount of the substitute payment should not be treated as "paid or accrued" at all for purposes of Section 59A where the substitute payment is made with respect to a repo that is treated as debt for tax purposes.

By contrast, in the case of a securities loan or a repo that is treated as a securities loan for tax purposes, the borrower of the security has income from any payment received on the security and a deduction with respect to any substitute payment made to the security lender.

There has been disagreement among practitioners and taxpayers as to whether substitute payments made to a related party qualify as Qualified Derivative Payments under the

Proposed Regulations. We recommend that Treasury revise Proposed Regulations Section 1.59A-6(d) to clarify that substitute payments on securities loans (and transactions treated as securities loans) are Qualified Derivative Payments because substitute payments are inherently derivative payments and would not be treated as Base Erosion Payments (and would not be made at all) if not made pursuant to a derivative. Such payments are necessarily part of the derivative component, rather than the non-derivative component, of a transaction. As a result, we recommend that Treasury withdraw the rule excluding securities lending and sale-repurchase transactions from the definition of derivative (and instead address the concern discussed above regarding repurchase premium and rebate interest amounts paid with respect to securities lending transactions and sale-repurchase transactions in a different manner). In this regard, with respect to securities loans, we believe it is significant that:

- When a taxpayer acquires securities with an obligation to return those securities and makes substitute payments, the taxpayer has posted cash collateral to the counterparty but has not received cash. This transaction is not a cash borrowing-type transaction with respect to the taxpayer (the specific concern expressed in the Preamble when describing why securities lending transactions were excluded from the definition of derivative). Moreover, economically, the taxpayer has not obtained additional resources, because the cash posted by the taxpayer has a value equal to or greater than the value of the security borrowed by the taxpayer.[82] Thus, even if the taxpayer sells the borrowed securities, the taxpayer has not increased the taxpayer's net cash position.

- The taxpayer is also not in the economically equivalent position to a borrower of cash; the taxpayer is exposed to risk with respect to changes in value of the security. For example, if the taxpayer uses the borrowed security to carry out a short sale, the taxpayer is fully exposed to changes in value of the security, and the obligation to make substitute payments represents a part of the taxpayer's exposure to the return on the security. Such an arrangement is not the equivalent of a debt instrument.[83]

- As a statutory matter, a securities borrowing fits within the definition of the term "derivative" as provided in Section 59A(h)(4)(A) as either a "short position" or other contract the value of which is determined by reference to the value of stock or indebtedness, and a securities loan is also a derivative in the ordinary sense of the word and serves the same functions as other types of derivatives.

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82 *Cf.* Section 956(c)(2)(J) (providing that "United States property" does not include "an obligation of a United States person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities").

83 This argument applies with more force to borrowings of stock than to borrowings of relatively low-risk, long-term debt securities, and it is possible that different rules could apply to borrowing debt securities and borrowing stock. However, as long as the borrower has not received cash or a cash equivalent from a related party, the result should not change, and the transaction should be treated as a "derivative."

While much of this analysis applies even in the case of substitute payments with respect to an uncollateralized securities borrowing of relatively risk-free debt, such transactions raise additional concerns. For example, assume that a taxpayer borrows short-term Treasury bills and posts no collateral; the taxpayer immediately sells the Treasury bills for cash; and, after 3 months (during which time the taxpayer pays any coupon on the Treasury bills to the lender as well as a borrowing fee reflecting the risk the lender has taken by lending on an uncollateralized basis), the taxpayer buys even shorter-term Treasury bills and redelivers them to the lender. Such a transaction may be viewed as economically equivalent to borrowing money, with the taxpayer exposed to the relatively small risk of changes in the value of the Treasury bills. In such case, it may be appropriate to treat payments made by the securities borrower (and in particular the borrowing fee paid by the securities borrower that reflects the credit risk of the securities borrower) as ineligible for the Qualified Derivative Payment exclusion, as these payments bear a strong resemblance to interest. In any event, we believe that such a rule should not alter the general treatment that we recommend of substitute payments as Qualified Derivative Payments.[84]

We request clarification regarding the application of the definition of Qualified Derivative Payment in respect of the types of transactions discussed above.

G. Proposed Regulations Section 1.59A-7

1. Aggregate approach to partnerships

Proposed Regulations Section 1.59A-7(b)(1) provides that Section 59A is applied at the partner level. The Preamble explains that the Proposed Regulations "generally apply an aggregate approach in conjunction with the gross receipts test for evaluating whether a corporation is an applicable taxpayer and in addressing the treatment of payments made by a partnership or received by a partnership for purposes of section 59A."[85] Thus, payments made by a partnership are generally treated as paid or accrued by each partner based on the partner's distributive share of items of deduction of the partnership, and payments made to a partnership are generally treated as paid or accrued to each partner based on the partner's distributive share of items of income or gain of the partnership.[86]

As discussed in the Prior Report, we believe that treating a partnership as an aggregate of its partners is consistent with the purposes of Section 59A. However, the language in the Preamble stating that a "partnership is treated as acquiring . . . property in exchange for an

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[84] We also would note that any rule that would attempt to identify securities lending transactions that are too debt-like by looking to the borrower's use of the securities would be very difficult to administer. This is because a securities dealer typically has securities on hand from a number of sources (including repos, securities borrowings, securities inventory and securities held on behalf of clients) and will often transfer some but not all of such securities in a variety of ways. Thus, it is not clear how a dealer would trace the borrowing of any particular securities to a specific sale or loan of such securities. Consequently, we encourage Treasury to address any concern about uncollateralized securities loans by looking solely to the terms of the securities borrowing without regard to how the securities are utilized by the borrower.

[85] Preamble at 65967.

[86] Proposed Regulations Section 1.59A-7(b)(2)-(3).

interest in the partnership under section 721" is misguided. To the extent that there is a base eroding transaction when property is contributed to a partnership under Section 721, it is the acquisition of a proportionate share of new property by the existing partners from a contributing partner, rather than an acquisition by the partnership in exchange for issuing its own interest. Further, in such a transaction, the existing partners would have paid for the new property with a proportionate share of the existing assets of the partnership. In that case, the contributing partner could equally be acquiring a proportionate share of the partnership's existing assets. In the case of a Section 721 contribution, relatedness should be tested at the level of the partners, and base erosion amounts can be passed through based upon allocations of depreciation deductions. The language in the Preamble relating to an acquisition in exchange for partnership interests appears to us to be misleading and in need of clarification.

2. De minimis exception

Proposed Regulations Section 1.59A-7(b)(4) provides that for purposes of determining a partner's Base Erosion Tax Benefits, a partner does not take into account its distributive share of any partnership amount of Base Erosion Tax Benefits for the taxable year if the partner's interest in the partnership represents less than ten percent of the capital and profits of the partnership at all times during the taxable year; the partner is allocated less than ten percent of each partnership item of income, gain, loss, deduction and credit for the taxable year; and the partner's interest in the partnership has a fair market value of less than $25 million on the last day of the partner's taxable year, determined using a reasonable method. We support the inclusion of this exception in final regulations.

H. Overall approach

The statutory language for Section 59A, a statute without precedent, emerged late in the drafting process for the TCJA, primarily from the Senate Finance Committee staff. We observed in the Prior Report that Section 59A contained, in our view, certain wording choices that appeared inconsistent with the statute's perceived purposes. Among the more obvious examples of this phenomenon was that the concepts underlying the application of the Gross Receipts Test and the Base Erosion Percentage Test and the definition of Base Erosion Payment needed to be consistently interpreted. And yet, the effectively connected income limitation in Section 59A(e)(2) applied only to the Gross Receipts Test, and the aggregation rule of Section 59A(e)(3) applied only to the Gross Receipts Test and the Base Erosion Percentage Test. The Proposed Regulations perform a commendable service in properly interpreting these provisions to give effect to legislative purpose. As we said above, we agree and appreciate this as the correct approach and correct interpretation of the statutory language. As another example, as discussed above, the Mark-to-Market Rule appropriately eliminates the double-counting of deductions that represent a single economic loss for purposes of the Base Erosion Percentage, even though Treasury elsewhere interprets Section 59A to require that the gross amount of deductible payments be taken into account.[87]

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[87] *See* Proposed Regulations Section 1.59A-3(b)(2)(ii) ("The amount of any base erosion payment is determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis.").

In other areas of the Proposed Regulations, however, Treasury's interpretations appear to be guided primarily by the words of the statute, without reference to the broader principles of reducing erosion of the U.S. tax base. For example, the Proposed Regulations interpret the add-back of net operating losses to Modified Taxable Income pursuant to Section 59A(c)(1)(B) as being limited to the Base Erosion Percentage of the net operating loss derived not with reference to the actual taxpayer or consolidated return but rather to the Base Erosion Percentage of the Applicable Taxpayer. As discussed above, the definition of Applicable Taxpayer in the Proposed Regulations often includes the U.S. branches of a foreign corporation whose financial results may be very different from, and not included in, the results of the related U.S. taxpayer or consolidated return members. This approach could produce planning opportunities that might dilute the effectiveness of the statute. In addition, as discussed above, Section 59A(c)(2)(C)(i) specifically excludes from the definition of Base Erosion Tax Benefit any payments that are subject to U.S. withholding tax pursuant to Sections 871 or 881. However, under the Proposed Regulations, payments of Excess Interest that are subject to U.S. withholding tax under Section 884(f)(1)(B) are not eligible for the same exclusion.[88]

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[88] *See* Part III.C.7 of this Report.

APPENDIX

Report No. 1397

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON BASE EROSION AND ANTI-ABUSE TAX

July 16, 2018

Table of Contents

Base Erosion and Anti-Abuse Tax[1]

I. **Introduction**

Among the many changes effectuated by the legislation commonly known as the Tax Cuts and Jobs Act[2] (the "**Act**"), one of the most novel is the Base Erosion and Anti-abuse Tax (the "**BEAT**"),[3] enacted as Section 59A.[4] The BEAT essentially imposes on U.S. corporations that meet the definition of "applicable taxpayer" a minimum tax on taxable income without regard to (i) payments to related foreign persons, and (ii) a certain percentage of net operating loss ("**NOL**") carryovers (taxable income so determined, "**Modified Taxable Income**").

The BEAT fits consistently within one of the central objectives of the Act of making U.S. corporations more internationally competitive.[5] In this case, that objective is promoted by reducing base erosion opportunities that have previously allowed foreign-controlled U.S. corporations to operate in the U.S. at lower effective tax rates than their U.S.-based competitors. Certainly, U.S. base erosion by foreign-controlled U.S. corporations had caused U.S. businesses to be more valuable on an after-tax basis to a foreign acquirer than to a U.S. acquirer, and the base erosion opportunity had apparently become a significant incentive for U.S. corporate inversions in recent years.[6] However, in addressing these issues, the BEAT restricts the full deductibility of payments which are already required to satisfy international arm's length transfer pricing standards. It also

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[1] The principal authors of this report are David Hardy and Stuart LeBlang. Substantial assistance was provided by Andy Braiterman, Peter Connors, Menachem Danishefsky, Lucy Farr, Julie Geng, David Hariton, Stephen Land, Michael Schler, Andy Solomon, Eric Solomon, Karen Gilbreath Sowell, and Gordon Warnke. Helpful comments were received from Daniel Altman, Peter Blessing, Robert Cassanos, Edward Gonzalez, Andrew Herman, John Lutz, John Narducci, Michael Peller, Stuart Rosow, Paul Seraganian, Stephen Shay, Michael Shulman, Willard Taylor, and Philip Wagman. Erika Nijenhuis and Yaron Reich provided helpful background information.

This report reflects solely the view of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution the budget for fiscal year 2018, P.L. 115-97.

[3] Act, Section 14401.

[4] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "**Code**") and the Treasury Regulations promulgated thereunder.

[5] *See* Unified Framework for Fixing Our Broken Tax Code (Sept. 27, 2017), https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf.

[6] The Congressional Budget Office, in discussing how companies benefit from inversions, states "[a]mong companies that inverted from 1994 through 2014 and that reported positive income in the financial year both before and after the inversion, the amount of worldwide corporate tax expense reported on their financial reports fell, on average, by $45 million in the financial year after the inversion." Congressional Budget Office, An Analysis of Corporate Inversions, September 2017, https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53093-inversions.pdf (last visited May 21, 2018).

has a disproportionate impact on U.S. companies that, for regulatory or commercial reasons, cannot replace intragroup transactions with third-party transactions or that have significant foreign taxes imposed on their offshore activities.[7]

The BEAT was introduced in the Act in conjunction with other similarly directed provisions of the new law, including the anti-hybrid provisions of Section 267A, the strengthened interest deduction limitation imposed under Section 163(j), the global intangible low taxed income ("**GILTI**") provisions in Section 951A, and the broadening of Section 367(d), governing outbound transfers of intangible property, to foreign goodwill. Unlike these other provisions, however, the BEAT has no predecessor in prior law, prior proposals by Congress,[8] or in the deliberations of the Organisation for Economic Co-operation and Development's ("**OECD**") Base Erosion and Profit Shifting initiatives ("**BEPS**").[9]

This report ("**Report**") considers the structure and context of the new BEAT and makes suggestions for the Department of the Treasury and the Internal Revenue Service (referred to collectively herein as "**Treasury**") to consider for regulations under Section 59A.The statutory language contains ambiguities as well as clear drafting errors that should be interpreted with a meaning that accomplishes its policy goals. This Report discusses the issues in the BEAT rules that we have identified so far and that we consider most significant. As a consequence, there are issues that are not covered in this Report.[10] In general, we comment on the statute as written without proposing revisions to it.

Part II provides background information and Part III is a summary of the BEAT and a detailed discussion of our recommendations.

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7 Where applicable, the BEAT due is the excess, if any, of the applicable percentage of Modified Taxable Income over regular tax liability reduced by, among other things, foreign tax credits. *See* discussion in Part II, *infra*. Accordingly, the greater the amount of foreign tax credits a U.S. corporation has, the greater its BEAT liability if it is subject to the BEAT.

8 Of note, the BEAT is a substantially different approach than the initially contemplated proposal to address base erosion, often referred to as the border adjustment tax or the destination-based cash flow tax.

9 Organisation for Economic Co-operation and Development BEPS Actions, https://www.oecd.org/ctp/beps-actions.htm (last visited Apr. 21, 2018). *See* Stephanie Soong Johnston, *U.S. BEAT Seems to Be 'Rough Justice,' OECD Tax Chief Says*, Tax Notes, Apr. 16, 2018, https://www.taxnotes.com/worldwide-tax-daily/base-erosion-and-profit-shifting-beps/us-beat-seems-be-rough-justice-oecd-tax-chief-says/2018/04/16/27z07 (Apr. 18, 2018) (reporting that Pascal Saint-Amans, director of the OECD's Centre for Tax Policy and Administration, in his keynote speech at a transfer pricing conference covered by the article, stated that "the BEAT is one provision that the OECD did not pursue in the BEPS project," and that "OECD had explored the idea of a minimum tax, but did not go that far because of resistance from some countries.")

10 One issue not covered in this Report, although significant, is the interaction of the BEAT with our treaty provisions. The Tax Section may consider this subject in a separate submission.

II. Background

The BEAT is imposed on taxpayers meeting the definition of Applicable Taxpayer, defined below, through a mechanical multi-step architecture. The Applicable Taxpayer must identify all payments made to a foreign person deemed to be related under the special attribution rules set forth in the statute[11] ("**Base Erosion Payment**"), and the current year's benefits from the Base Erosion Payments[12] ("**Base Erosion Tax Benefit**"). The Applicable Taxpayer then compares its Base Erosion Tax Benefits to its total deductions for the taxable year (the "**Base Erosion Percentage**").[13] Modified Taxable Income for purposes of the BEAT generally is what the taxpayer's taxable income would be if it were determined without regard to (i) the Base Erosion Tax Benefits,[14] and (ii) the Base Erosion Percentage of NOLs.[15] The BEAT is then the excess, if any, of the specified percentage ("**Specified Percentage**")[16] of Modified Taxable Income over the corporation's regular tax liability reduced by certain specified tax credits, including all foreign tax credits ("**Specified Tax Credits**") (the "**Base Erosion Minimum Tax Amount**").[17] Thus, to have BEAT liability, a taxpayer must both (i) be an Applicable Taxpayer, and (ii) have the Specified Percentage of Modified Taxable Income that exceeds regular tax liability reduced by Specified Tax Credits.

The definition of Applicable Taxpayer is a corporation (other than a regulated investment company (RIC), real estate investment trust (REIT) or an S corporation) with $500 million of gross receipts on average for the three prior taxable years[18], and a Base Erosion Percentage of at least 3 percent of its total deductions.[19] For purposes of determining gross receipts and certain other BEAT calculations, Section 59A(e)(3) contains an aggregation rule providing that certain related persons shall be treated as one person. In the case of gross receipts of foreign persons, Section 59A(e)(2) states that only gross receipts constituting effectively connected income ("**ECI**") shall be taken into account (the "**ECI Limitation**"). These rules appear to be intended to restrict the

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11 Section 59A(d).

12 Section 59A(c)(2).

13 Section 59A(c)(4).

14 Section 59A(c)(1)(A).

15 Section 59A(c)(1)(B).

16 Five percent for calendar year 2018, 10 percent for calendar years 2019-2025, and 12.5 percent for calendar year 2026 and thereafter. Section 59A(b)(1)(A), (2)(A). For groups with a bank or securities dealer, the rate is increased by one percentage point, in each case. Section 59A(b)(3).

17 Section 59A(a), (b).

18 Section 59A(e)(1)(B).

19 Section 59A(e)(1)(C). Groups with a bank or a securities dealer have a decreased Base Erosion Percentage of 2 percent. *Id.*

application of BEAT to large U.S. enterprises that have incurred substantial amounts of related party base eroding payments.

As noted above, the Base Erosion Percentage is calculated by comparing an Applicable Taxpayer's Base Erosion Tax Benefits to its total deductions for the taxable year.[20] For this purpose, the same aggregation rule is used to determine the $500 million gross receipts threshold, but the ECI Limitation is not specifically incorporated.[21]

For purposes of determining Base Erosion Payments, related persons are those who are deemed related under Sections 267(b) or 707(b) to the taxpayer or to a 25 percent owner of the taxpayer, using broadened Section 318 attribution rules.[22] In addition, the statute includes entities that are treated as related under Section 482 standards, which might include two unrelated companies operating in concert or entities commonly owned by unrelated parties.[23] "Payments" for this purpose do not include payments that reduce taxable income but are not treated as deductions[24], such as cost of goods sold ("**COGS**")[25], or certain service payments eligible for reimbursement at cost.[26]

Once Base Erosion Payments have been identified, it is then necessary to calculate Base Erosion Tax Benefits, which are the deductions allowed by the Code for the taxable year relating to those payments (as opposed to the gross payments themselves).[27] For example, in the case of a payment for the acquisition of depreciable property and other capitalized payments, the annual Base Erosion Tax Benefit is the depreciation (or amortization) deduction available therefor with respect to that property for the taxable year in question.[28] For a corporation whose interest expense is limited by Sections 163(j) or 267, the deduction is a Base Erosion Tax Benefit only to the extent currently allowable under such rules.[29] Base Erosion Tax Benefits also include services expenses[30]

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20 Section 59A(c)(4).

21 *See* Section 59A(e)(3).

22 Section 59A(g)(1)(A), (1)(B), (3).

23 Section 59A(g)(1)(C).

24 Section 59A(d)(1).

25 Section 59A(c)(2)(A)(iv). An exception to this rule is entities considered to be "expatriated" under Section 7874(a)(2). *See* Section 59A(d)(4).

26 Section 59A(d)(5).

27 Section 59A(c)(2).

28 Section 59A(c)(2)(A)(ii).

29 Section 59A(c)(2)(A)(i).

30 *See* Section 59A(d)(5).

and re-insurance premiums[31], among others. Payments to related foreign persons that are subject to full U.S. withholding tax are excluded from Base Erosion Tax Benefits.[32] Payments eligible for a reduced rate under an applicable treaty are treated as producing Base Erosion Tax Benefits only to the extent no withholding tax is imposed,[33] determined in a manner similar to the pre-Act Section 163(j)(5)(B) rules.[34] This withholding tax exception applies in computing Modified Taxable Income and Base Erosion Percentage, but notably not to the computation of gross receipts.[35]

Next, Modified Taxable Income is calculated "without regard to any" Base Erosion Tax Benefit[36] or the Base Erosion Percentage of NOLs.[37]

The final step is to calculate the Base Erosion Minimum Tax Amount, if any.[38] Outside of the BEAT context, tax credits generally reduce the taxpayer's regular tax liability and are valuable tax assets. For purposes of the BEAT regime, however, reductions of regular tax liability through the utilization of Specified Tax Credits increase the likelihood of there being a Base Erosion Minimum Tax Amount, effectively devaluing those credits.[39] For taxable years beginning on or before 2025, however, regular tax liability is not reduced by certain credits (*e.g.*, research and development credits) and is not reduced by the full amount of certain other tax credits, thereby preserving some or all of the value of those credits to the taxpayer through the end of those taxable years.[40]

Section 59A includes a broad grant of regulatory authority in subsection (i). That subsection grants authority to "prescribe such regulations as may be necessary or appropriate…",

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31 Section 59A(c)(2)(A)(iii).

32 Section 59A(c)(2)(B).

33 Section 59A(c)(2)(B)(i).

34 Section 59A(c)(2)(B)(ii).

35 Section 59A(c)(2)(B)(i)(II).

36 Section 59A(c)(1)(A).

37 Section 59A(c)(1)(B).

38 Section 59A(b).

39 *See* Section 59A(b)(1)(B).

40 Section 59A(b)(1)(B), (2)(B), (4).

in addition to authority to address several specific enumerated issues.[41] Those enumerated issues include unrelated parties, conduits and avoidance transactions.[42]

III. Discussion and Recommendations

A. Observations Regarding the Statutory Language and Context

As discussed further below, the language of Section 59A contains certain ambiguities and inconsistencies that result in what we believe are unintended consequences and, in some cases, may not successfully implement the apparent legislative purpose of the provision. In light of the broad grant of regulatory authority in Section 59A(i), as a general matter, we believe that Treasury has authority to construe the provision logically in regulations to implement its legislative purpose, even in the absence of literal statutory support. We offer a few observations below related to the more significant aspects of the BEAT that may help to inform the resolution of ambiguities and uncertainties created by Section 59A.

The definition of Applicable Taxpayer focuses on gross receipts, which is not a measure of taxable income and, therefore, has not been the subject of precise prior guidance. Further, gross receipts is not a measure of earnings for financial statement purposes and thus, it may not always result in the identification of appropriate taxpayers upon which to impose the BEAT. Consequently, gross receipts has the potential to be manipulated to avoid Applicable Taxpayer status without substantively affecting the taxpayer's regular tax liability or its financial statement earnings. The BEAT does not apply to items resulting in a reduction of gross income (*e.g.*, COGS)[43] and, other than timing, the Code does not often distinguish between COGS (as a reduction from gross income) in calculating gross income and other deductible items.[44] The inclusion of the COGS exception means that businesses that sell tangible products (whether manufactured in the U.S. or abroad) will fare differently under the BEAT than those in industries whose products are capital or services. For example, banks and service companies may incur substantial costs as preconditions to their business offerings (such as interest expense) that are deductions under the Code, rather than reductions of gross receipts, and accordingly are not excluded from Base Erosion Payments.[45]

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[41] Section 59A(i).

[42] Section 59A(i)(1)(A).

[43] *See* Section 59A(c)(2).

[44] There are, however, exceptions. For example, Section 280E denies deductions for expenditures in connection with the illegal sale of drugs but does not restrict reduction on gross income for COGS in connection with such activities. The PFIC definition in Section 1297(a) is based on gross income, which reflects reductions for COGS but not for deductible expenditures.

[45] As discussed further below, certain of the generally applicable BEAT mechanics seem ill-equipped for financial services businesses. For example, the $500 million annual gross receipts threshold, which might seem quite large for industrial companies, seems quite small in the case of multinational banks.

While, historically, the principal focus by Congress and Treasury on base erosion involved deductible financial payments (*e.g.*, for interest or the use of intangibles),[46] which are highly portable and can be remitted across borders with little or no withholding tax, the BEAT extends the focus to a variety of other related party payments, including payments for tangible property and certain services, and applies even where transfer pricing standards are satisfied. Traditional base eroding payments have been the focus of many international initiatives aiming to backstop normal transfer pricing rules with additional anti-abuse measures and to further international coordination among taxing jurisdictions in order to prevent base erosion and eliminate double taxation.[47] For example, Action 4[48] and Action 8[49] of the BEPS Project are designed to combat interest stripping and other forms of base erosion that arise in the context of cross-border intragroup trade.[50] The new BEAT has not been considered as part of the international coordination initiatives.[51]

Finally, some have suggested that the BEAT has a role that is broader than policing related party base eroding payments, citing the effective elimination of the foreign tax credit from the calculation of the Base Erosion Minimum Tax Amount. We note that Base Erosion Payments, as outbound payments, may or may not generate foreign taxes or foreign tax credits. This makes the effective elimination of the foreign tax credit in calculating the Base Erosion Minimum Tax Amount difficult to understand. It is likely that the treatment of foreign tax credits as Specified Tax Credits will result in more U.S. multinationals becoming subject to the BEAT.

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46 *See, e.g.*, the Senate Finance Committee's section-by-section summary of the Act, which explains that "currently, foreign-owned U.S. subsidiaries are able to reduce their U.S. tax liability by making deductible payments to a foreign parent (or foreign affiliates). This often results in earnings stripping when deductible related-party payments are subject to little or no U.S. withholding tax. Foreign parents often take advantage of these deductions through the use of interest, royalties, management fees, or reinsurance payments from the U.S. subsidiary" (https://www.finance.senate.gov/imo/media/doc/11.13 percent20Section percent20by percent20Section.pdf). In addition, in remarks made Feb. 13, 2018 at the Brookings Institution's Tax Policy Center, Senate Finance Committee Chairman Orrin Hatch (R-Utah) said that the BEAT "places limits on the extent to which U.S. companies can deduct interest and royalty payments to parent companies offshore" (https://www.finance.senate.gov/chairmans-news/hatch-touts-business-tax-reform-at-tax-policy-center).

47 For example, BEPS Action 8 (*see* note 49) , was focused on achieving transfer pricing rule consistency between jurisdictions to reduce instances of double taxation.

48 Action 4 generally recommends a net interest expense cap, similar to what Congress put in place in amended Section 163(j). *See* OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update, http://www.oecd.org/tax/beps/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2016-update-9789264268333-en.htm (last visited May 31, 2018).

49 *See* OECD, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports, http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm (last visited May 31, 2018).

50 *See* OECD, BEPS Actions, http://www.oecd.org/tax/beps/beps-actions.htm (last visited May 31, 2018).

51 *See* note 9.

B. Applicable Taxpayer

1. Gross Receipts

The use of gross receipts, rather than taxable income (the traditional measure of taxation), for purposes of the $500 million threshold, will present challenges of first impression for Treasury guidance. Gross receipts is a less precisely defined term than gross income or taxable income. However, the gross receipts test is similar to the one used for determining whether a corporation may use the cash receipts and disbursements method of accounting under Section 448(c)(1).[52]

For example, sales of products that are subject to return or allowance are generally netted against the original gross receipts.[53] Further, a lender holding a note would not consider the repayment of its loaned principal as gross receipts, but only the interest on such loan as gross receipts. Additional guidance will need to be provided in order to determine a corporation's gross receipts, particularly for banks and other financial services corporations. For certain highly leveraged businesses, such as banks and other financial intermediaries, the gross receipts amount may not provide a true measure of the size of a taxpayer's U.S. business.

Because the gross receipts amount does not directly correlate with the resulting taxable income, it is vulnerable to manipulation. Sophisticated taxpayers might, for example, construct offsetting positions with unrelated persons to inflate the denominator of the Base Erosion Percentage.[54] Such arrangements should be the subject of regulations applicable to the use of conduits and unrelated persons as intermediaries, discussed below.

2. Imposition of Tax

Section 59A(a) imposes the BEAT on "each applicable taxpayer" (previously defined herein as an Applicable Taxpayer) meeting the gross receipts and Base Erosion Percentage thresholds. Section 59A(e)(3) prescribes the "controlled group" as the relevant unit for determining average gross receipts and Base Erosion Percentage of an Applicable Taxpayer. Specifically, Section 59A(e)(3) provides:

> "all persons treated as a single employer under subsection (a) of Section 52 shall be treated as 1 person for purposes of this subsection and subsection (c)(4), except that in applying Section 1563 for purposes of Section 52, the exception for foreign

52 Notably, Section 59A(e)(2)(B) specifically references certain rules of Section 448(c)(3): "[r]ules similar to the rules of subparagraphs (B), (C), and (D) of section 448(c)(3) shall apply in determining gross receipts for purposes of this section." Subparagraphs (B), (C), and (D) provide rules for short taxable years, reductions of gross receipts, and treatment of predecessors, respectively.

53 *See* Section 59A(e)(2)(B) cross referencing Section 448(c)(3).

54 This particular scenario is addressed below in Part III.L discussing conduit arrangements.

corporations under Section 1563(b)(2)(C) shall be disregarded" (herein referred to as a "**controlled group**")

However, because Section 59A imposes the BEAT on each Applicable Taxpayer, the statute might literally be read as imposing a single tax on the entire controlled group. If the BEAT tax were imposed upon the controlled group as a whole, it would need to be apportioned among the group members for liability and earnings and profits purposes. Section 59A does not prescribe any rule for which entity might be required to pay the controlled group's BEAT. With respect to a controlled group of 50 percent commonly owned domestic and foreign corporations, the group may not have any mechanism under contract or tax law for collecting the liability from its constituent members. Only U.S. corporate members of a 50 percent commonly owned controlled group that satisfy the 80 percent affiliation standard of Section 1504[55] may join in a consolidated tax return, and foreign corporate members of such controlled group cannot join in a consolidated return with their U.S. affiliates or with other foreign related corporations.[56] The most obvious apportionment method would be to calculate each controlled group member's BEAT on a separate return basis and then to allocate the aggregate tax based upon the individual member's separate return tax. This method, at best, achieves the same result of applying the tax separately at the outset.

We believe that the intent of the provision, in defining Applicable Taxpayer, is not to impose a single tax under Section 59A upon the controlled group to then be apportioned among members of the controlled group. Rather, we think the provision is designed to say that in calculating the gross receipts threshold and the Base Erosion Percentage, all members of the controlled group should be aggregated. We believe that individual corporations within the controlled group filing separate returns or consolidated groups within such controlled groups will bear their own BEAT tax (or as members of a consolidated return) based upon the corporation's or consolidated group's Base Erosion Tax Benefits. In the case of members of a controlled group filing a consolidated U.S. income tax return, we believe that the BEAT tax calculated for the consolidated return group would be allocated among the individual members for liability and earnings and profits purposes under the consolidated return rules for separate taxable income in Treas. Reg. § 1.1502-12.

3. Aggregation Rule

Section 59A intends to identify deductible payments with base erosion benefits made by U.S. corporate taxpayers to their foreign affiliates that are not U.S. corporate taxpayers.[57] The BEAT mechanics and definitions, however, suffer from imperfect drafting, including the definition of Applicable Taxpayer.

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[55] Section 1504(a)(2).

[56] Section 1504(b). For the limited contiguous country corporation exception, s*ee* Section 1504(d).

[57] *See* Section 59A(c)(2)(B) which excludes from Base Erosion Tax Benefits payments subject to U.S. withholding tax under Sections 1441 and 1442 in proportion to the extent of maximum withholding rates.

This aggregation rule included in the definition of Applicable Taxpayer is critical to the gross receipts threshold, the Base Erosion Percentage, and other provisions of the section, and significantly impacts the scope of the new BEAT.

a. Gross Receipts Threshold

The aggregation rule, noted above, provides that all members of the same "controlled group of corporations" (using the Section 1563 definition with a 50 percent ownership threshold and without the exclusion for foreign corporations), shall be treated as a single employer.[58] As a result, the Applicable Taxpayer for purposes of the BEAT may include multiple domestic corporations, which if less than 80 percent commonly-owned will not be consolidated, and may include foreign corporations that will generally not be consolidated. In addition, Section 59A(e)(2) states for purposes of the gross receipts threshold that "in the case of a foreign person the gross receipts of which are taken into account for purposes of paragraph (1)(B), only gross receipts which are taken into account in determining income which is effectively connected with the conduct of a trade or business within the U.S. shall be taken into account" (*i.e.*, the ECI Limitation).[59]

In determining the scope of the BEAT, consideration must be given to whether flows of goods, services and capital between various members of a controlled group should be eliminated or aggregated, and whether such amounts are counted only once as they leave the U.S. taxing jurisdiction or multiple times. In this respect, paragraph (3) says that "all persons treated as a single employer . . . shall be treated as one person . . ." As a result, a payment from one member of the controlled group of corporations to another member of the same controlled group of corporations would be disregarded as effectively a payment between branches of a single person.

A substantially similar aggregation rule used in applying the gross receipts threshold for the cash receipts method of accounting under Section 448(c) is interpreted in that same manner. Regulations thereunder state, "transactions between persons who are treated as a common employer ... shall not be taken into account in determining … the gross receipts test."[60] The principles for applying Section 448(c) are referred to in Section 59A.[61] This same intra-controlled group exclusion is appropriate in our view in order to eliminate double counting of gross receipts for the BEAT. If the rule were otherwise interpreted, controlled groups could multiply gross receipts and associated deductions with intra-controlled group transactions and artificially inflate the denominator of the Base Erosion Percentage, and smaller taxpayers may be swept into the BEAT because intragroup transfers might result in multiplied gross receipts that exceed the $500 million threshold. Accordingly, for purposes of the gross receipts threshold, regulations should

58 Section 59A(e)(3).

59 Certain taxpayers eligible for treaty protection may be in receipt of amounts that are ECI but that are not subject to U.S. tax because they are not considered to be attributable to a U.S. permanent establishment. We believe that the ECI Limitation should treat such tax treaty protected receipts as non-ECI for purposes of the ECI Limitation in order to conform treaty rules with U.S. domestic rules to the extent possible.

60 *See* Treas. Reg. § 1.448-IT(f)(2)(ii).

61 *See* Section 59A(e)(2)(B).

confirm that transactions between controlled group members are excluded ("**intra-controlled group exclusion**").

b. Base Erosion Percentage

The same aggregation rule under Section 59A(e)(3) that applies for purposes of the gross receipts threshold is also applied for purposes of the Base Erosion Percentage threshold in subsection (c)(4). The Base Erosion Percentage is defined in subsection (c)(4) as the Base Erosion Tax Benefits of the taxpayer for the year over the total allowable deductions. We assume that the intra-controlled group exclusion would also operate to exclude deductible payments between affiliated U.S. corporations (and between such corporations and U.S. branches of affiliated foreign corporations) from the denominator of the Base Erosion Percentage. However, if the intra-controlled group exclusion of the aggregation rule were generally incorporated into Section 59A so as to capture payments to foreign entities within the controlled group as well, then all payments to foreign affiliates would be excluded, often causing the Base Erosion Percentage to be zero (except in the case of Base Erosion Payments to related persons outside of the controlled group).

We believe that the incorporation of the aggregation rule into Section 59A(c)(4) makes sense only if the ECI Limitation also applies. The ECI Limitation, however, is not literally applicable to the calculation of the Base Erosion Percentage. If the ECI Limitation were incorporated into the Base Erosion Percentage, then only ECI receipts of foreign corporations would be considered and only such ECI receipts and payments would be subject to intra-controlled group exclusion. If the intra-controlled group payments were excluded only for U.S. corporations and the ECI of foreign corporations, then payments to foreign affiliates not subject to U.S. tax--the actual Base Erosion Payments--would be properly identified. With that addition, the language would correctly exclude only payments among U.S. taxpayers.

c. Base Erosion Payment

Under subsection (d) of Section 59A, a Base Erosion Payment is defined as an amount paid or accrued by the taxpayer to a related foreign person. Curiously, neither the aggregation rule applicable for determining Base Erosion Percentage under subsection (c)(4), nor the ECI Limitation applicable to the gross receipts threshold, is incorporated into the definition of Base Erosion Payment under subsection (d). Thus, Base Erosion Payment has a different meaning standing alone, than when used in calculating Base Erosion Tax Benefits, upon which the Base Erosion Percentage depends.

This inconsistency compounds when Base Erosion Payments are considered in the calculation of Modified Taxable Income.[62] In that calculation, Modified Taxable Income is calculated by adding Base Erosion Tax Benefits and the Base Erosion Percentage of NOLs to the taxpayer's taxable income (or recalculating taxable income without regard to such payments). As explored above,[63] the Base Erosion Percentage applicable to NOLs is calculated *with* the intra-

62 *See* Section 59A(c)(1).

63 *See also* further discussion at Part III.N., *infra*.

controlled group exclusion, while literally the Base Erosion Payments for the current year is calculated *without* the intra-controlled group exclusion. Consider a situation where a Base Erosion Payment of $100 causes the taxpayer to have a $50 loss. In that situation, the same Base Erosion Payment that is generating a loss would be calculated *without* the intra-controlled group exclusion to the extent utilized in Year 1 and then *with* the intra-controlled group exclusion when carried forward and utilized in Year 2. This inconsistency cannot have been intended.

If, for purposes of the Base Erosion Percentage under subsection (c)(4) and for the Base Erosion Payment under subsection (d), the intra-controlled group exclusion and the ECI Limitation were incorporated, then Base Erosion Payments would count payments to foreign affiliates that were not ECI and would exclude those that are ECI payments. Payments that are ECI are not Base Erosion Payments as contemplated by the statute.[64]

We note further that, as drafted, payments by a U.S. corporation to a U.S. branch of a foreign controlled group member are treated as Base Erosion Payments. ECI payments to a U.S. branch are not base eroding.

We believe that Treasury should provide guidance interpreting the Base Erosion Payment definition to incorporate both the intra-controlled group exclusion and the ECI Limitation. Without such guidance, the statute does not operate properly.

C. <u>Related Party</u>

For purposes of determining Base Erosion Payments to related persons, Section 59A calculates relationships broadly by including persons who are 25 percent related to the taxpayer by vote or value, and other persons related to the taxpayer or the 25 percent owner under Sections 267(b) or 707(b)(1).[65] In addition, persons related within the meaning of Section 482 are treated as related persons for purposes of the BEAT.[66] In determining such relationships, the statute applies the constructive ownership rules of Section 318 rules, but applies a 10 percent threshold (instead of a 50 percent threshold) in upward attribution cases and disregard downward attribution from a foreign person to a US person.[67] We note that the statute does not distinguish among payments with differing base erosion incentives (*e.g.*, a reduction in U.S. income taxed at the 21 percent rate does not economically justify sharing payments with a 75 percent unrelated person).

We are concerned that the scope of the related party rules may frequently exceed the scope of information access. We recommend that consideration be given to providing that the reporting

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64 *See* Senate Floor Colloquy of Senators Lindsay Graham and Orrin Hatch, 163 Cong. Rec. No. 207, at S8108 (Dec. 19, 2017) ("**Senate Floor Graham-Hatch Colloquy**") (Mr. Graham stated, "[B]ase erosion payments do not include amounts paid to a foreign affiliate that are subject to U.S. income tax. For example, payments to a foreign partnership by a U.S. taxpayer that the foreign partnership certifies are effectively connected income are not base erosion payments. The income has not been shifted offshore, and there has been no erosion of the tax base.")

65 Section 59A(g)(1)(A), (B).

66 Section 59A(g)(1)(C).

67 Section 59A(g)(3).

requirements added by the Act to Section 6038A(b)[68] permit taxpayers to demonstrate inaccessibility in certain lesser relationship contexts. Further, we are concerned that the subjective elements of the Section 482 relationships, such as persons acting in concert,[69] will result in uncertainty regarding the BEAT. We suggest that Treasury consider whether the application of the additional Section 482 related person relationship could be limited in some way.

D. Branch ECI Receipts – Non Controlled Group Members

It is possible that, in certain fact patterns, the U.S. branch of a foreign corporation might be a related party to an applicable payor-taxpayer under Section 59A(g), but not be treated as a member of the same controlled group from which the payment is derived.[70] In such an instance, the branch's receipt of ECI would not be eliminated under the literal application of the subsection (e)(3) aggregation rule. Of course, to the extent that a branch of a foreign corporation receives an ECI payment subject to U.S. tax, base erosion has not actually occurred. Such branch will indeed have to include such amount in its taxable income, and file in its own tax return, from which it can establish that it has not itself engaged in base eroding activity.[71] For this reason, we believe that Treasury should provide guidance interpreting the statute to disregard ECI payments received by a U.S. branch of a foreign corporation that is not a member of the payor's controlled group.

Some have questioned whether U.S. branches of foreign corporations with large losses from prior activities may not be fully equivalent to U.S. taxpayers. We generally believe that NOLs based upon prior economic losses should be available to offset future income from debt cancellation or business improvement. There does not seem to be a reason to treat a U.S. branch with losses differently from a U.S. subsidiary of a foreign corporation with NOLs. Therefore, we see no need for a special rule for branches with losses.

Under the double tax treaties the U.S. has adopted, foreign corporations protected by a treaty are taxed only on their income attributable to a U.S. permanent establishment. While the permanent establishment standard is not identical to the effectively connected income standard of U.S. domestic law, the provisions are similar and aimed at a common objective. Thus, we believe that receipts that are not attributable to a U.S. permanent establishment should be treated as Base Erosion Payments and those that are attributable to a U.S. permanent establishment and are subject to tax should have the benefit of the ECI Limitation of Section 59A(e)(2).

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68 Act, Section 14401(b).

69 *See* Treas. Reg. § 1.482-1(i)(4).

70 Any foreign person 25 percent commonly owned would be "related" but must be 50 percent commonly owned to be a controlled group member.

71 *See* Senate Floor Graham-Hatch Colloquy.

E. Cost of Goods Sold - Embedded Intangibles

Under Section 59A(d)(1), a Base Erosion Payment is defined as including, among others, "any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter." Because a COGS payment is reflected as a reduction in gross income rather than a deduction from a taxpayer's income for purposes of computing how much tax is due, it is not included in the above definition of a Base Erosion Payment. The legislative history makes this point explicit: "Base erosion payments do not include payments for cost of goods sold (which is not a deduction but rather a reduction to income)."[72] For certain payments that result in reductions in gross income (and not in deductions from income), however, the statute specifically provides that such payments will be included as Base Erosion Payments. These payments include (i) certain reinsurance payments (generally treated as reductions in the gross amount of premiums and not as deductions)[73] and, (ii) amounts paid or accrued to a related party that is a surrogate foreign corporation that reduce gross receipts under Section 7874 inverted after November 9, 2017[74]. While the statutory language excludes from the definition of Base Erosion Payment nearly all payments that result in reductions of gross income rather than in deductions, for simplification, we will refer to it as the "**COGS exclusion**".

The COGS exclusion from Base Erosion Payments was clearly meant to provide relief for a taxpayer that either buys raw materials or partially manufactured components and inputs for manufacture and assembly in the U.S. or imports manufactured goods for resale in the U.S.[75] However, the COGS exclusion effectively also applies to otherwise deductible royalties and other payments reflecting the value of intangibles that are capitalized under Section 263A or that are effectively embedded in the price of an imported tangible item, the value of which consists largely of intellectual property (*e.g.*, pharmaceutical products), and thus treated as COGS.[76]

72 U.S. Congress, Joint Committee of Conference, *Joint Explanatory Statement of the Committee of Conference*, 528 (Dec. 18, 2017) (https://docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf) ("**Conference Report**").

73 Section 59A(d)(3).

74 Section 59A(d)(4). Treas. Reg. § 1.448-1T(f)(2)(iv) provides that gross receipts are not reduced by COGS or by cost of property sold if such property is described in Section 1221(1), (3), (4) or (5). If this rule is applied to Section 59A(d)(4), it could substantially limit the application of the anti-inversion provision to the cost of capital assets or assets used in a trade or business. It appears that the statute intended to refer to a reduction in "gross income" rather than "gross receipts".

75 While taxpayers may be able to capitalize certain service costs or interest costs (and these costs may effectively be embedded in COGS along with intangible costs such as royalties), we focus our attention on amounts associated with intangible property given the increased base erosion risk they pose.

76 Section 263A and regulations effectively require capitalization of manufacturing certain royalties as "indirect costs" to the extent that they "directly benefit or are incurred by reason of the performance of production or resale activities." Following a dispute relating to sales royalties (*see Robinson Knife Mfg. Co. v. Comm'r*, 600 F.3d 121 (2d Cir. 2010)) (*i.e.*, royalties calculated as a percentage of net sales), a regulation was issued that clarified that even these types of sales-based royalty payments must be included in COGS. Treas. Reg. § 1.263A-1(e)(3) identifies which indirect costs properly allocable to property produced or property acquired for resale must be

The exclusion from Base Erosion Payments of royalties included in COGS effectively eliminates the application of the BEAT to most payments (including potentially Base Erosion Payments) related to the value of intellectual property ("**IP**") to the extent the payments are connected to the production of goods. Thus, multinational corporations in certain industries with a heavy IP component that generate income from production and/or sale of goods will have a lesser BEAT exposure than corporations in certain other businesses, including corporations engaged in IP-heavy industries that generate revenue from licensing of IP, advertising or services, and banks and other financial services companies. This distinction raises the question of whether Treasury should address the scope of the COGS exclusion in regulations.

1. Statutory Intent

The statutory language would suggest that Congress intended that the application of the BEAT be limited for U.S. operations of multinational groups (such as manufacturers or distributors) that purchase products or foreign-sourced component parts from foreign related parties or license intellectual property from foreign related parties for use in U.S. manufacturing operations. A rationale for this may be that where the full price of an imported good (including the royalty payment for the value of related intangibles such as patents, trademarks, and know-how) is consistent with arm's length transfer pricing principles, there is no reason for the U.S. to impose an additional tax cost. This approach views the BEAT as aimed predominantly at base erosion through financing arrangements.

On the other hand, it can be argued as a policy matter that the COGS exclusion should be circumscribed at least in certain circumstances where capitalized or embedded royalties present significant base erosion opportunities.[77] Royalties were clearly targeted by the BEAT and have been the focus of international anti-base erosion initiatives.[78] If the BEAT's COGS exclusion exempts from the regime all royalties that are capitalized pursuant to Section 263A (including royalties embedded in the cost of imports acquired from an affiliate), the scope and impact of the statute is reduced significantly.

2. Regulatory Authority

Section 59A(i)(1) states simply that "[t]he Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of this section". The statute then enumerates specific regulations that shall be prescribed, including regulations to

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capitalized under Section 263A because they are incurred "by reason of the performance of production or resale activities even if the costs are calculated as a percentage of revenue or gross profit from the sale of inventory, are determined by reference to the number of units of property sold, or are incurred only upon the sale of inventory." The regulation contains an example of royalty costs that must be capitalized.

77 This conclusion is bolstered by the fact that the BEAT specifically excludes Base Erosion Payments to the extent such payments are subject to withholding tax on fixed or determinable annual or periodic income.

78 Financial flows such as payments for reinsurance premiums, interest, and royalties present the greatest opportunity for base erosion.

prevent avoidance of the tax through the use of transactions "designed" to substitute payments not subject to the BEAT for payments subject to the BEAT.[79]

Given the statutory language and clear legislative history that acknowledges that the statute does not extend to COGS, we do not believe that Treasury should issue regulations that contract the COGS exception.[80] If Treasury were to consider issuing such regulations, any such regulations would need to be tailored to address scenarios only where application of the COGS exception is presumed to be abusive or at least in contravention of the BEAT's intended scope. Further, we believe it would be inappropriate to distinguish between taxpayers that set up their business model *ab initio* and those that change their supply chain structure to minimize deductible BEAT payments related to IP. If Treasury were to consider an anti-abuse rule, conceivably it could focus on capitalized royalties for IP (i) developed in the U.S. and transferred offshore; (ii) developed offshore, but using substantial U.S.-source financing for the research and development; and/or (iii) developed with substantial input from U.S.-based research and development teams. We believe that such a rule would be difficult to develop and administer, considering the many factual permutations and varying business practices, as well as the inherent arbitrariness of attempting to provide administrative rules distinguishing between appropriate and inappropriate uses of the COGS exclusion in light of the clear provisions of the statute and legislative history.

We considered whether a rule could be drafted that would treat royalties capitalized under Section 263A differently from royalties embedded into the price of a product. The Tax Section believes that such a distinction would create a perverse incentive as it would discourage U.S. manufacturing activity and encourage imports where IP value is embedded in the cost of the import. Furthermore, we believe that such a distinction would be inappropriate in the absence of clear statutory authority.

F. Services Cost Method Payments

Section 59A(d)(5) contains an exception from Base Erosion Payments for service payments, which under Section 482 are permitted to be reimbursed at cost under the services cost method ("**SCM**")[81]. This exclusion of SCM compensation will help to avoid over-application of the BEAT to transactions having no true base erosion potential.

Under Section 482, generic services not critical to the profit-making activity of an enterprise may be shared among members of a related party group and compensated at cost under the SCM, without a profit element. Section 59A(d)(5) states that Base Erosion Payments shall not include:

> "any amount paid or accrued by a taxpayer for services if (A) such services are services which meet the requirements for

[79] Section 59A(i).

[80] *See* note 72, *supra*. Regulatory authority, if any, does not go as far as to exclude all capitalized payments for the use of IP from the COGS exception.

[81] *See* Treas. Reg. § 1.482-9(b).

> eligibility for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and (B) such amount constitutes the total services cost with no markup component."

The statutory language in clause (B) states that "such amount constitutes the total services cost with no markup component." This language could be interpreted to reflect the intention of the drafters that only generic services compensated at cost are eligible for the exclusion and that any profit element added thereto disqualifies such payments entirely. Interpreted in such a manner, a slight overstatement of cost which, when reviewed upon audit, allowed a small profit to emerge, would disqualify the payment entirely from the BEAT exclusion. Further, under the laws of their home country, some recipients of SCM compensation may be required to earn a profit on their services provided. Multinational groups often have worldwide procedures for pricing intragroup services, requiring a profit component, which must be applied consistently across various jurisdictions that have opposing interests in the group's taxation. These taxpayers would also not have the benefit of the exclusion of SCM costs.

A substantial majority of the Tax Section does not believe that the permitted exclusion of SCM cost from the definition of Base Erosion Payments should be lost entirely merely because there is a profit element in excess of the actual cost. Generally, tax legislation attempts to avoid such a "cliff" effect that chills otherwise permissible behavior. However, we note that the Conference Report restates the language of clause (B) that the exception applies "only if payments are made for services that have no markup component." [82] A floor colloquy in the Senate regarding an earlier draft of the exclusion approved the bifurcation of services payments between the cost and profit elements.[83] Notably, this earlier draft did not include the parenthetical in clause (A), providing that services eligible for SCM "(determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)" (the "**significant services parenthetical**") can qualify for the exception from the definition of Base Erosion Payments.

The language in Section 59A(d)(5) may be difficult to fully harmonize. Under Treas. Reg. § 1.482-9(b)(5), significant services cannot qualify for the SCM method and such services are required to have a profit component.[84] The addition of the significant services parenthetical permits the payor to exclude from BEAT any payments for services that normally would not qualify for the SCM because they are significant services for which service providers are required to charge

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82 The Conference Report at 658 continued to state "only if payments are made for services that have no markup component."

83 Senate Floor Colloquy of Senators Rob Portman and Orrin Hatch, 163 Cong. Rec. No. 196, at S7697 (Dec. 1, 2017). *See* Martin A. Sullivan, *Can Marked-up Services Skip the BEAT?,* Tax Notes, 706 (Feb. 5, 2018).

84 Treas. Reg. § 1.482-9(b)(5) provides, "A service cannot constitute a covered service unless the taxpayer reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group."

a markup. Interpreting the statute to exclude amounts paid for significant services only if the taxpayer does not pay any markup would make the final law's relaxation of the prior proposal meaningless, since taxpayers must pay an arm's length profit bearing price for "significant" services.

The statute should be interpreted in a manner which gives meaning both to the significant services parenthetical in Section 59A(d)(5)(A) and to the "no markup" provision in (B). If "such amount" in Section 59A(d)(5)(B) refers to the cost "component of amount paid or accrued … for services …", then both parts of the exclusion have meaning. We recommend that the SCM exclusion be construed to mean that the actual cost element of services compensation is to be treated as excludable from Base Erosion Payments and the possibility of an additional profit component should not negate the exclusion treatment of such cost "amount".

An alternate approach that might respond to the spirit of the words would be to permit the exclusion of otherwise qualifying SCM compensation provided that the taxpayer only deducts an amount which in good faith represents the cost of such services. If amounts in excess of cost were actually paid, such profit amounts would be treated as capital distributions or contributions (as the case may be).

A minority of the Tax Section believes that the better reading of the statute is that the exclusion of payment of the cost of otherwise qualifying SCM services generally applies only if there is no profit component, that this interpretation is the only one that is consistent with Congressional intent as reflected in the language of the Conference Report ("only if payments are made for services that have no markup component"), and that the best way to reconcile this rule with the significant services parenthetical is to allow a markup only in the case where that parenthetical applies. The minority believes, however, that the SCM exclusion should apply if the taxpayer believes in good faith that the amount paid represents solely the cost of such services.

G. <u>Base Erosion Payments – Payments to a CFC</u>

Payments between U.S. corporations and related CFCs within the same controlled group of corporations would be regarded as Base Erosion Payments under the terms of the statute, even where such amounts were immediately taxable to the paying U.S. shareholders.[85] For example, if a U.S. corporation makes a payment to its 100 percent-owned foreign affiliate, such payment would represent a payment to a related foreign person. While not entirely clear, such payment if not representing ECI might not be eliminated as a payment among members of the controlled group under the aggregation rule of Section 59A(e)(3). In this case, the payment to the CFC would be treated as a Base Erosion Payment giving rise to Base Erosion Tax Benefits. In the hands of the recipient CFC, however, such payment might be treated as Subpart F income[86], either as foreign personal holding company income in the case of certain royalties or interest not earned by an active

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[85] This result assumes that the intra-controlled group exclusion and the ECI Limitation does not apply for purposes of determining a Base Erosion Payment.

[86] *See* Section 952.

finance exception beneficiary,[87] or potentially as foreign base company sales or services income[88], and taxed currently to the U.S. shareholder of such CFC.[89] By virtue of being in the taxable income of the U.S. shareholder, the Subpart F income is also included in the Modified Taxable Income of the U.S. shareholder for BEAT purposes, regardless of whether the CFC is taxed locally on the Subpart F income. As a result, disallowing the deduction for the payment to the CFC, but including the Subpart F income, would mean that Modified Taxable Income would reflect the income but not the deduction, and would be higher than if the deductible payment had not been made in the first place. Because the payment is included as income for purposes of Modified Taxable Income and the BEAT is computed without regard to foreign tax credits, no adjustment should be necessary for any foreign taxes associated with the income.

The statute does not on its face suggest an exclusion for payments to a CFC even if a simultaneous Subpart F inclusion is required. However, we believe it is reasonable for Treasury to consider allowing a taxpayer to exclude such payments from Base Erosion Payments and Base Erosion Tax Benefits, if the payor-taxpayer identifies the recipient CFC, elects to exclude the payments from Base Erosion Payments and Base Erosion Tax Benefits, and the payor-taxpayer includes the payments in income. Thus, if a U.S. shareholder owns 55 percent of CFC and an unrelated person owns the remainder, and the U.S. shareholder makes a payment to the CFC that is included in Subpart F income, then the U.S. shareholder could elect to exclude 55 percent of the payment from its Base Erosion Payments and Base Erosion Tax Benefits calculations and only 45 percent of the payment would be subject to the BEAT.[90]

Under Section 951A of the Code, a new type of current inclusion of CFC income has been introduced for GILTI.[91] Inclusions of GILTI by U.S. shareholders that are corporations are reduced by a 50 percent deduction under Section 250(a)(1)(B). For BEAT purposes, the current inclusion of GILTI income presents the same concurrence of U.S. deduction and U.S. inclusion that a Subpart F inclusion would, but because the Section 250 deduction results in only a 50 percent inclusion, the benefits/detriments do not fully offset. We suggest that regulations for Subpart F inclusions, if proposed, consider a similar BEAT exclusion for the amount of the net GILTI inclusion (*i.e.*, net of the Section 250 deduction). As in the case of Subpart F inclusions, no additional adjustment is necessary for GILTI foreign tax credits.

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87 Section 954(h).

88 Section 954(d), (e).

89 Section 951.

90 If Treasury agrees that netting should be allowed for payments that result in an inclusion by the payor-taxpayer, consideration should be given to whether similar relief should be available where U.S. shareholders other than the payor-taxpayer include the payment in income. We recognize that extending the recommendation in this regard might result in administrative or other complexities.

91 Act, Section 14201.

H. Base Erosion Payments – Qualified Derivatives

Qualified derivative payments are exempted from both the numerator and the denominator of the Base Erosion Percentage. Under Section 59A(h)(2)(A), the term "derivative payment" means any qualified derivative payment made pursuant to a derivative, together with other requirements that are discussed below.

The scope of the qualified derivative payment exemption (the "**QDP Exemption**") is bounded by four requirements: (1) the payment must be made pursuant to a "derivative"[92]; (2) the taxpayer must mark the derivative to market and recognize ordinary income, gain and loss with respect to it[93]; (3) the payment must not be a Base Erosion Payment on a standalone basis or be allocable to a non-derivative component[94]; and (4) certain reporting requirements must be met.

1. The "Derivative" Requirement

The term "derivative" is defined extremely broadly. Under Section 59A(h)(4), it means any contract (including any option, forward contract, futures contract, short position, swap or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more specified items. The specified items are (i) any share of stock in a corporation, (ii) any evidence of indebtedness, (iii) any commodity which is actively traded, (iv) any currency and (v) any rate, price, amount, index, formula or algorithm.[95]

Category (v), particularly the subcategories of "price" and "amount," would seem to enable a derivative to refer to any item that can be valued or quantified, even if the item is not of the type on which derivatives have historically been written. It is not clear whether such a broad reading was intended. On the one hand, a broad reading of category (v) would potentially make categories (i)-(iv) superfluous.[96] On the other hand, the "derivative" definition closely resembles other similarly broad definitions used in previous derivatives' mark-to-market proposals, including a proposal initiated by former House Ways and Means Committee Chairman Dave Camp in 2014 and the more recent Modernization of Derivatives Act. We observed in Reports 1389, 1365 and 1318 that the definition of "derivative" in those proposals was almost unlimited and could, for example, pick up ordinary non-derivative transactions such as automobile leases.[97] In light of this history, it is reasonable to infer that a broadly defined term was intended.

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92 Section 59A(h)(2)(A).

93 Id.

94 Section 59A(h)(3).

95 Section 59A(h)(4)(i)-(v).

96 It would also appear to make the "actively traded" requirement of Section 59A(h)(4)(A)(iii), applicable to commodities, moot.

97 New York State Bar Association Tax Section, Report No. 1389, *Report on Proposed Mark-to-Market Legislation* (Feb. 8, 2018); New York State Bar Association Tax Section, Report No. 1365, *Report on the Discussion Draft*

As a practical matter, because of the other requirements of the QDP Exemption, in particular the ordinary/mark-to-market requirements discussed below, the broad definition of "derivative" may have somewhat limited practical consequence. Accordingly, while consideration could be given to constraining the definition in some way, such an effort seems unnecessary in light of the other limitations and may in any event be contrary to Congressional intent if the aim (as reflected in the language) was to provide a broad rule.

The definition of derivative includes a couple of additional rules. American depository receipts ("**ADRs**") and similar instruments with respect to shares of stock in foreign corporations are treated as such shares, unless Treasury determines otherwise.[98] This rule presumably clarifies that a contract with respect to an ADR can be an approved derivative. Another rule provides that the term derivative does not include any insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or comparable foreign corporation).[99]

One question is whether payments on securities loans are eligible for the QDP Exemption. Securities lending transactions may be used by securities dealers to acquire securities necessary to cover a short position, and we understand that the resulting obligation to return identical securities (effectively, the resulting short position) is marked to market by such dealers under Section 475. Such transactions are also described in the Section 59A(h) definition of "derivative," as contracts with payments determined by reference to stock or debt. For these reasons, we believe that payments on a securities loan, including borrowing fees paid by a dealer to acquire a security under such a loan, are eligible for the QDP Exemption. On the other hand, interest on collateral posted to secure a securities loan should be a Base Erosion Payment, even if it is made under the auspices of a securities lending agreement, because collateral is generally viewed as separate for tax purposes from the transaction it secures.[100]

2. The Mark-to-Market and Ordinary Requirements

The QDP Exemption applies only if the taxpayer marks to market the derivative for tax purposes and recognizes ordinary income and loss with respect to it. Specifically, the taxpayer must "recognize[] gain or loss as if such derivative were sold for its fair market value on the last business day of the taxable year (and such additional times as required by this title or the taxpayer's method of accounting)...".[101] The taxpayer must treat gain or loss arising on this mark-to-market

of the Modernization of Derivatives Tax Act of 2016 (Feb. 23, 2017); New York State Bar Association Tax Section, Report No. 1318, *Report on the House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments and Corresponding Proposals by the Obama Administration* (Mar. 6, 2015).

98 Section 59A(h)(4)(B).

99 Section 59A(h)(4)(C).

100 *See* Part III.H.3 below regarding standalone Base Erosion Payments.

101 Section 59A(h)(2)(A)(i).

as ordinary,[102] and must treat all items of income, deduction, gain or loss with respect to a payment pursuant to the derivative as ordinary.[103]

Although not stated in the legislative history, the purpose of the ordinary/mark-to-market requirement was presumably to limit the QDP Exemption to derivatives dealers, who generally mark their derivatives positions to market and treat them as ordinary income under Section 475.[104] However, because the ordinary/mark-to-market requirement does not reference Section 475, it potentially applies to other categories of taxpayers and transactions, such as traders electing a mark-to-market method of accounting under Section 475(f) and taxpayers entering into foreign currency contracts that are marked to market under Section 1256(b)(1)(B)[105] and are ordinary by reason of Section 988. It is unclear whether the latter two categories of taxpayers were intended to benefit from the QDP Exemption. Prop. Treas. Reg. § 1.988-7 also provides a mark-to-market regime for Section 988 gain or loss in respect of Section 988 transactions, which taxpayers may rely on even prior to finalization.[106] In the case of a derivative that gives rise solely to Section 988 gain or loss, a taxpayer would appear to have satisfied the ordinary/mark-to-market requirement. Given that these regulations were proposed in December 2017, after the first version of the QDP Exemption had been publicly released, it seems unlikely that this result was specifically contemplated by the drafters of Section 59A. Nonetheless, while Prop. Treas. Reg. § 1.988-7 is available to any taxpayer, and therefore broader in certain respects than Section 475, the scope of transactions that would potentially be eligible for the QDP Exemption by reason of the regulation would be limited to Section 988 derivatives such as forwards, swaps and options.

As noted above, the ordinary/mark-to-market requirement provides an effective limit on the types of transactions that fall within the QDP Exemption. Section 475 applies only to derivatives that relate to stock, beneficial ownership interests in widely-held partnerships or trusts, debt, currencies and actively-traded commodities; interest rate, currency or equity notional principal contracts; and certain hedges of other Section 475 securities or commodities.[107] As a result, although a Section 59A(h) "derivative" includes any contract that references an "amount" or "price," the contract will generally only benefit from the QDP Exemption if it fits within one of Section 475's fairly limited categories of financial instruments or is a Section 988 transaction that is marked to market under Section 1256 or Prop. Treas. Reg. § 1.988-7.

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[102] Section 59A(h)(2)(A)(ii).

[103] Section 59A(h)(2)(A)(iii).

[104] *See* letter of ISDA and SIFMA, dated Nov. 17, 2017, to Senator Orrin Hatch and Rep. Ron Wyden.

[105] Because Section 1256 applies only to foreign currency contracts traded in the interbank market, presumably only groups that include financial institutions may benefit from this category of contracts eligible for the QDP Exemption. *See* Section 1256(g)(2)(A)(ii).

[106] *See* Prop. Treas. Reg. § 1.988-7.

[107] Section 475(c)(2).

3. Standalone Base Erosion Payments and Non-Derivative Components

The QDP Exemption includes a pair of rules that appear to be designed to prevent taxpayers from attempting to wrap a Base Erosion Payment into a derivative. The first is that a payment is not eligible for the QDP Exemption if it "would be treated as a Base Erosion Payment if it were not made pursuant to a derivative, including any interest, royalty, or service payment…" (a "**standalone Base Erosion Payment**").[108] The second excludes a payment that is properly allocable to a non-derivative component, in the case of a contract that has both derivative and non-derivative components.[109]

The second rule is the more straightforward of the two: it appears to be aimed at situations where a derivative provides for payments unconnected to the core derivative element. So, for example, if a taxpayer were to construct a contract that functions as an interest rate swap, but built into the agreement a series of payments determined by reference to an unrelated aspect of the taxpayer's business, such as rental payments for office space, those other payments would not be within the QDP Exemption.

The drafting of the first rule, applicable to standalone Base Erosion Payments, makes its scope somewhat unclear. One possible reading is that it effectively eliminates the QDP Exemption entirely, because no qualified derivative payment would be one if it were not made pursuant to a derivative. Also, virtually every notional principal contract (*i.e.*, swap), which is clearly intended to qualify for the QDP Exemption, has a "fixed" leg denominated by reference to an interest rate on a notional principal amount. Such a reading cannot be a rational interpretation of the language, as it would be inconsistent with Congress's evident aim in enacting the QDP Exemption. A more rational reading is that the rule is aimed at transactions, or portions of transactions, that under general tax principles are treated as non-derivative transactions that give rise to cognizable categories of Base Erosion Payments (including, but not limited to, the specified categories of interest, royalties and service payments). So, for example, a deemed loan pursuant to a notional principal contract that has significant nonperiodic payments under Treas. Reg. § 1.446-3(g) would give rise to interest that can be a Base Erosion Payment. Similarly, interest on collateral would give rise to potential Base Erosion Payments, even if the collateral is required to be posted under the terms of a derivative contract. While ordinary course derivatives provide for financing elements (*e.g.*, the LIBOR leg of a swap), those elements are fundamental to the derivative itself and should not be viewed as standalone Base Erosion Payments. This interpretation results in a rule that overlaps to some degree with the non-derivative component rule discussed above, but strikes an appropriate balance between capturing abusive transactions and giving effect to the purpose of the QDP Exemption.

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108 Section 59A(h)(3)(A).

109 Section 59A(h)(3)(B).

4. The Reporting Requirement

Under Section 59A(h)(2)(B), no payments benefit from the QDP Exemption for any taxable year unless the taxpayer "includes in the information required to be reported under Section 6038B(b)(2) with respect to such taxable year such information as is necessary to identify the payments to be so treated and such other information as the Secretary determines necessary to carry out the provisions of this subsection." It appears that the cross reference is in error and should be to Section 6038A(b)(2) which, as amended, refers to Base Erosion Payments. Section 6038A(b)(2) requires an applicable taxpayer to report "such information as the Secretary determines necessary to determine the Base Erosion Minimum Tax Amount, Base Erosion Payments, and Base Erosion Tax Benefits of the taxpayer for purposes of section 59A for the taxable year, and such other information as the Secretary determines is necessary to carry out such section." Until Treasury provides forms or rules to implement Section 6038A(b)(2), the reporting requirement does not appear to be self-executing. Moreover, given the language of Section 59A(h)(2)(B), the operation of the QDP Exemption itself does not appear to depend on the Treasury's prior implementation of the reporting rules; if no information is presently "required to be reported" under Section 6038A(b)(2), the Section 59A(h)(2)(B) reporting requirement is simply inoperative.

As drafted, the reporting requirement (when operative) appears to function as a cliff: if the taxpayer fails to comply in any way, it loses the entire benefit of the QDP Exemption for the taxable year.[110] We recommend that Treasury issue rules with a compliance standard that is less extreme, in that it would only affect derivatives that the taxpayer fails to report (or fails to report properly), rather than all derivatives of the taxpayer for the taxable year.

5. Mark-to-Market Losses and Netting

Many financial institutions will be dealers under Section 475. As noted above, dealers are required to mark their derivative positions at year-end, and the marking of a derivative at a loss gives rise to a deduction under Section 165. Because the loss may be disconnected in time and amount from a specific payment, there is a question as to whether, in the context of a derivative entered into with a related party, that deduction can be considered a Base Erosion Tax Benefit that is "with respect to" a Base Erosion Payment. Even if a mark-to-market deduction could be viewed this way, the "payment" would in most cases be eligible for the QDP Exemption, in which case the deduction would be excluded from both the numerator and denominator of the Base Erosion Percentage. On the other hand, if a mark-to-market deduction on a related-party derivative were not "with respect to" a Base Erosion Payment/qualified derivative payment, the deduction for the

[110] The portion of the Conference Report that discussed the reporting requirement can be read to support the conclusion that any reporting failure causes the entire QDP Exemption to be lost, in that it says "[n]o payment is treated as a qualified derivative payment unless the taxpayer includes in the information required to be reported under section 6038B(b)(2) with respect to such taxable year such information as is necessary to identify the payments to be so treated and such other information as the Secretary of the Treasury determines necessary to carry out the provision." However, in the final statutory language, the beginning of the comparable sentence says "[n]o payments shall be treated as qualified derivative payments…". While still somewhat unclear, this revised language leaves room for an interpretation that is consistent with our recommendation that a reporting failure affect only the payment to which the failure relates.

mark would be reflected in the denominator but not the numerator of the Base Erosion Percentage by reason of it being a deduction allowable to the taxpayer under Section 59A(c)(4)(A)(ii)(I).

The fact that there may be no clearly associated payment makes the analysis unclear. For example, a domestic securities dealer may enter into a three year forward contract with a foreign related party at the beginning of Year 1 that results in a mark-to-market loss deduction of $50 in Year 1, is flat in Year 2, and reverses in year 3 with the result that the dealer receives a payment of $25 at the end of year 3. Given that the domestic dealer never makes a payment to its foreign affiliate, treating its mark-to-market deduction as being "with respect to" such a payment would seem to require a very expansive reading of the legislative language. On the other hand, there may be mark-to-market deductions that are much more closely associated with an actual cash payment. For example, a domestic securities dealer could enter into a one year forward contract with a foreign related party in Year 1 that settles on January 2 of Year 2. In that case, a mark-to-market loss by the domestic dealer at the end of Year 1 will closely approximate the cash payment that is about to come due, and therefore is more easily seen as being "with respect to" a qualified derivative payment.

It may be very difficult to draw lines between cases where the mark-to-market deduction is tied to a payment and those where it is not, and few cases will be as simple as the second example above. As a result, where a related-party derivative is eligible for the QDP Exemption, a more viable approach would be for Treasury to determine either that (1) all such mark-to-market deductions on the derivative are treated as deductions associated with qualified derivative payments (and therefore excluded from both numerator and denominator) or (2) all such deductions are in a separate deduction category that is eligible to be in the denominator (and is not in the numerator). It may be appropriate to seek a technical correction to obtain the first result, which seems more in line with the legislative intent that QDPs be excluded from both the numerator and denominator.

On the one hand, mark-to-market deductions arise because of a method of accounting, and to view them as being a form of "payment" will often not reflect reality, as in the first forward example above. However, not treating them as payments within the QDP Exemption could have the effect of causing a large proportion of a dealer's related party derivatives to increase the Base Erosion Percentage denominator in ways perhaps not intended.

With respect to third party derivatives, there are also questions as to the circumstances under which payments under a notional principal contract should be netted for purposes of the Base Erosion Percentage denominator calculation. For instance, assume a taxpayer makes payments on the fixed leg of an interest rate swap in exchange for floating payments on the same interest rate swap. Under Treas. Reg. § 1.446-3(d), periodic and nonperiodic payments on a notional principal contract during a single taxable year are required to be netted, which is generally consistent with the contractual obligations in an International Swaps and Derivatives Association ("**ISDA**") confirmation. For this reason, the net amount of all such payments made by a taxpayer during a taxable year on a single notional principal contract should be treated as giving rise to a deduction during such year for purposes of the Base Erosion Percentage denominator. More generally, we believe that the determination of whether derivative items should be netted, or reflected as gross items, in the Base Erosion Percentage denominator should be determined by the treatment of such payments under general tax law (whether specific rules such as Treas. Reg. §

1.446-3 or applicable common law principles). This may be driven by the terms of the contractual arrangement.

I. Base Erosion Payments – Interest Deductions of Branches

U.S. branches of foreign corporations may be subject to the BEAT when they deduct payments made to related foreign persons. Under U.S. domestic tax principles, the U.S. branch files a U.S. corporate income tax return reporting its income effectively connected with its U.S. trade or business less any deductions incurred in order to generate such ECI. When a U.S. branch of a foreign corporation is entitled to a deduction, the BEAT consequences must be determined in the context of other associated aspects of U.S. tax law. The application of the BEAT to interest deductions of a U.S. branch merits further discussion.

The interest expense of a U.S. branch (or other ECI-related activity) of a foreign corporation for a taxable year is determined under a three-step formula under Treas. Reg. § 1.882-5, under which, *first*, the amount of the corporation's U.S. assets (essentially, ECI-related assets) is determined; *second*, the amount of U.S.-connected liabilities is determined by multiplying the amount of U.S. assets by either the actual worldwide debt-to-assets ratio of the foreign corporation or the fixed ratio (95 percent in the case of a bank and 50 percent in the case of other taxpayers); and, *third*, the amount of interest expense is calculated, by multiplying the amount of U.S.-connected liabilities by an interest rate as determined under either the "adjusted U.S. booked liabilities" method or the "separate currency pools" method.[111]

1. Branch Interest

Regardless of the method that a foreign corporation applies to calculate its interest expense under the third step of the Treas. Reg. § 1.882-5 formula, the Code provides that interest expense on U.S. booked liabilities ("**Branch Interest**"),[112] which generally consist of liabilities to separate legal persons that are properly reflected on the branch's books,[113] shall be treated as if it were paid by a domestic corporation for all purposes of Subtitle A of the Code[114]. Therefore, we believe that Branch Interest expense is treated as paid to the branch's creditor for purposes of Section 59A.

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[111] *See* Treas. Reg. § 1.882-5.

[112] *See* Treas. Reg. § 1.884-4(b)(1).

[113] *See* Treas. Reg. § 1.882-5(d)(2).

[114] Section 884(f)(1)(A) (limited to the amount of interest allocable to ECI under Treas. Reg. § 1.882-5).

2. Excess Interest

The excess of the amount of a foreign corporation's interest allocated or apportioned to ECI under Treas. Reg. § 1.882-5 over the amount of Branch Interest is referred to as Excess Interest.[115]

The Excess Interest deduction is notional; it can be analogized to a deemed borrowing by the branch from its head office, which ordinarily would be disregarded for federal income tax purposes.[116] Thus, it is not itself a payment or accrual to any person as is necessary to be a Base Erosion Payment under Section 59A(d). In the past, when Congress has intended to treat Excess Interest as if it were a regarded payment or accrual to a person (such as the foreign corporation's home office) for federal income tax purposes, it has so specified, as it has for purposes of the branch level interest tax and the old earnings stripping rules.[117] Congress did not specify that Excess Interest would be treated as if it were a payment or accrual to any person for purposes of Section 59A.[118] In sum, the literal language of Section 59A(d) suggests that BEAT is inapplicable to Excess Interest.

However, if Excess Interest were to be exempted from the BEAT, a foreign corporation could reduce its BEAT liability by, for example, either (i) conducting its U.S. operations through a U.S. branch that would receive funding from its home office and that would give rise to Excess Interest, or (ii) funneling funding to its U.S. subsidiaries through a U.S. branch, which would claim a deduction for Excess Interest but would receive interest on loans to its U.S. subsidiaries that would also be exempt from the BEAT (as discussed in Part III.D above).

Moreover, we do not believe that the foregoing literal reading of Section 59A is the only acceptable reading, given that Excess Interest is treated under the Treasury Regulations as an allocation or apportionment to ECI of a portion of the foreign corporation's third-party interest expense.[119]

Accordingly, we believe that Excess Interest should not be entirely exempt from BEAT. Rather, consistent with the Treasury Regulations, Excess Interest should be treated as an allocation or apportionment of a ratable portion of the foreign corporation's third-party interest expense to

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115 *See* Treas. Reg. § 1.884-4(a)(2).

116 *See*, *e.g.*, Treas. Reg. § 1.882-5(c)(2)(viii).

117 *See* Section 884(f)(1)(B), Treas. Reg. § 1.884-4(a)(2) (branch level interest tax), former Section 163(j)(9)(C) prior to the Act, and Prop. Reg. § 1.163(j)-8. *See* also the rules under Treas. Reg. § 1.267(a)-3 that apply to Branch Interest but not to Excess Interest.

118 Indeed, Congress included an exemption from the BEAT for interest subject to tax under Sections 871 and 881 and withheld under Sections 1441 and 1442, but not for Excess Interest subject to tax under Sections 881 and 884, suggesting that the BEAT does not apply to Excess Interest. *See* Section 59A(c)(2)(B)(i).

119 *See, e.g.*, Treas. Reg. §§ 1.882-5(a)(1)(i) ("The amount of interest expense of a foreign corporation that is allocable under section 882(c) to income which is (or is treated as)" ECI), 1.884-4(a)(2)(i)(A) ("The amount of interest allocated or apportioned to ECI of the foreign corporation under § 1.882-5 for the taxable year").

its ECI activities (*i.e.*, its U.S. branch). To the extent the foreign corporation has borrowed from a related foreign person, a ratable portion of the Excess Interest would be treated as a payment to a related foreign person for purposes of Section 59A. However, this look-through treatment of Excess Interest should be subject to the affirmative use of conduit principles as described in Part III.L below, which is particularly important to address the concerns raised by financial institutions' mandated interest payments as discussed in Part III.J below.

Thus, for example, assume that a foreign bank that is a subsidiary of a foreign bank holding company provides debt funding to its U.S. subsidiaries through its U.S. branch. In conformity with applicable bank regulatory requirements, the bank holding company has issued regulatory capital securities to third-party investors and has on-loaned the proceeds to its bank subsidiary in the form of internal regulatory debt capital. Under our recommendation, in determining the extent to which Excess Interest of the bank's U.S. branch is subject to Section 59A, the portion of the bank's internal regulatory debt capital that is allocable to its U.S. branch should be treated as a borrowing from third parties rather than from a related foreign person.

3. Possible Application of Section 267A

Some have suggested that Section 267A (relating to payments by hybrid entities) might treat Excess Interest as a payment by the U.S. branch to the U.S. branch's home office and therefore a disqualified related party amount if the home office does not include the Excess Interest in its income. If Section 267A denied the deduction, then no Base Erosion Tax Benefit could arise. A full consideration of the scope of Section 267A, including the nature of related party payments to which it applies[120] is beyond the scope of this Report. Absent such clarity relating to Section 267A, it becomes more important that regulations prescribe the treatment of the Excess Interest deductions under the rules of Section 59A.

4. Authorized OECD Approach

Treas. Reg. § 1.882-5(a)(2) allows for the interest expense deductions of a U.S. Branch to be calculated pursuant to the authorized OECD approach ("**AOA**") pursuant to those U.S. income tax treaties that expressly allow for such alternative method of calculating interest expense deductions in the U.S. The AOA has also been approved for use by certain taxpayers pursuant to advance pricing agreements entered into with treaty partners. The AOA generally results in a deduction for interest in excess of interest paid on U.S. booked liabilities, determined under rules analogous to arm's length transfer pricing principles, after the imputation of equity capital to the branch. Thus, the AOA generally permits the deduction of Excess Interest in much the same manner as by Treas. Reg. § 1.882-5 discussed above. Therefore, we recommend that BEAT regulations specify that such interest deductions under the AOA, exceeding the deductions on branch booked liabilities, are to be treated in the same manner as Excess Interest under Treas. Reg. § 1.882-5 for BEAT purposes.

[120] *See* Section 267A(b)(1), (2).

J. Financial Institutions' Mandated Interest Payments

Section 59A singles out banks and securities dealers for special treatment. Such taxpayers are subject to a slightly higher BEAT tax rate[121] and a lower Base Erosion Percentage threshold.[122] For this purpose, Section 59A(b)(3)(B) identifies as "a bank (as defined in Section 581) …". Section 581 states, "the term 'bank' means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any state …". Thus, the literal language would not apply to the U.S. branch of a multinational banking enterprise because that bank would be incorporated outside the United States. Because the U.S. branches of multinational banks are thought to be intended subjects of the BEAT, this interpretation appears to be a mistake. We believe the language of subsection (b)(3)(B) should be interpreted as entities conducting a banking business as defined in Section 581, wherever incorporated (similar to the definition in Section 585(a)(2)(B), without regard to the second sentence thereof).

In order to minimize the risk of global financial instability, international banking regulators have adopted many rules intended to strengthen banks' capital position, improve liquidity and provide for "resolution" of a failed bank without the need for taxpayer money to be injected into the bank. For example, internationally agreed banking rules require the largest banking groups to maintain minimum outstanding levels of loss absorbing securities, which may include both regulatory capital instruments and long term unsecured debt that does not qualify as regulatory capital (together, "Total Loss Absorbing Capacity" ("**TLAC**") securities). TLAC securities are structured as stable capital that can absorb losses during periods of economic stress and are sized so that the securities can absorb losses on a going concern and a gone-concern basis. The Federal Reserve requires the largest foreign banking groups to hold their significant U.S. financial operations (other than their branches) under a top-tier U.S. intermediate holding company ("**IHC**") and, beginning in 2019, will require IHCs to issue TLAC securities, including very large amounts in the form of long-term debt.

The terms of a banking group's TLAC securities depend on the banking institution's stated resolution strategy. The regulators prefer (and some require) a single point of entry ("**SPOE**"). Under SPOE, the strategy for resolving a failing banking institution is for the home regulator to take the top-tier holding company into resolution while the group's lower-tier banking and other subsidiaries continue to operate without the need for resolution. This minimizes risk to other financial institutions and limits cross-border regulatory conflicts over failing financial groups. If a banking group has adopted or been required to adopt a SPOE strategy, the group's top-tier holding company issues TLAC securities externally, and usually is required to push-down funding with similar terms to regulated subsidiaries through the issuance of "internal on-loan securities" (often referred to as "internal TLAC"). Losses of the entire banking group are pushed up to the top- tier

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[121] Section 59A(b)(3) increases the normal BEAT tax rate by one percentage point.

[122] Section 59A(e)(1)(c) lowers the Base Erosion Percentage on banks and securities dealers to 2 percent from 3 percent.

holding company (usually through the internal on-loan securities mandated by the regulators), whose external TLAC securities absorb the group's losses.

Separately, however, the Federal Reserve's regulations size each IHC's TLAC securities in an amount necessary to maintain the IHC group as a going concern in periods of economic stress in order to protect the U.S. financial system. As is the case with banking regulators in other countries, the Federal Reserve's SPOE strategy regulations require the IHC to issue its TLAC securities to its foreign parent or to a wholly owned foreign subsidiary of its foreign parent ("internal" TLAC securities). Issuing internal TLAC securities ensures that losses within the IHC group that threaten its going concern status are pushed up to the foreign parent, where external securities will absorb those losses. It also eliminates the risk of a disorderly second point of regulatory resolution that could occur if third parties held TLAC securities of a failing IHC group.

This regulatory mandated structure creates large amounts of related party interest expense. Specifically:

> (1) In the case of external securities required by the home regulator, the top-tier holding company issues external securities and separately funds lower tier subsidiaries under "internal on-loan securities". Consequently, the required issuance of external securities leads to intercompany interest expense from U.S. subsidiaries on these internal on-loan securities that is potentially subject to BEAT, and
>
> (2) The Federal Reserve's requirement that the IHC's foreign parent (or its wholly owned foreign subsidiaries) purchase the IHC's internal TLAC debt securities causes the IHC to pay any interest on those instruments to related foreign parties, which is potentially subject to BEAT.

The legal requirements to issue regulatory mandated securities in specified forms and to specified purchasers are generally consistent throughout the developed world and result from careful regulatory analysis and action by the Federal Reserve and equivalent foreign regulators. The terms of these intercompany instruments are separately subject to regulatory control to ensure that their pricing is arm's length.

Other banking regulations also require banks to provide funding to their U.S. operations. For example, U.S. subsidiaries of a foreign bank must hold "high-quality liquid assets" ("**HQLA**") in amounts necessary to ensure that they can weather a liquidity crisis. The source of HQLA is typically the foreign bank, either through a sale-and-repurchase agreement treated as secured debt for U.S. tax purposes or through an actual loan that is used to acquire the HQLA. More generally, with the exception of foreign banks that carry out retail operations in the United States and therefore must operate through a domestically licensed bank, both U.S. and foreign bank regulators expect and/or require banks to source their long-term funding from third parties at the top-tier entity, and to lend it down to branches and subsidiaries to the extent that they cannot raise sufficient funding locally.

The legislative history of Section 59A demonstrates that Congress intended the BEAT to prevent abusive of tax deductions to erode the U.S. tax base.[123] Abusive behavior is implicitly voluntary. Interest expense on regulatory mandated securities would not seem to implicate Congress' concerns regarding abusive base erosion, given that the issuance of these securities is not voluntary; they are required by regulations in both the home country and the host country, including by the Federal Reserve for significant U.S. operations of foreign banking organizations. As noted above, the regulatory requirements are generally consistent throughout the developed world, and pricing of the securities is subject to regulatory supervision. Moreover, as described above, the ultimate capital provider for such regulatory mandated securities are unrelated to the U.S. branch or its foreign parent corporation.

We recommend that Treasury exercise its regulatory authority over the definition of "related party" to exclude interest paid to a foreign party in respect of TLAC and other regulatory mandated securities so long as the ultimate capital provider is not a related party. This interpretation of Section 59A is consistent with Treasury practice recognizing the inherent differences between banking and other commercial enterprises, such as different elective levels of U.S. connected liabilities for U.S. branches of foreign banks than for other commercial enterprises.[124] It is also consistent with Congress' expressed intent to level the playing field between U.S. and foreign-owned multinationals.

K. <u>Partnerships</u>

The BEAT is applicable to corporations and groups of corporations but is generally silent as to its application to partnerships. A controlled group of corporations representing an Applicable Taxpayer may own partnership interests or may own other controlled group members through partnerships. Accordingly, payments by partnerships, to partnerships, or through partnerships could have a significant effect on the calculation of the gross receipts threshold, the Base Erosion Percentage and the determination of Base Erosion Payments.

Generally in the Code, items received by a partnership or paid by a partnership that potentially are treated differently at the partner level, are allocated to individual partners for evaluation at the partner level.[125] This is commonly referred to as the aggregate theory of partnerships. Alternatively, for some purposes, a partnership is treated as an entity and the tax rules are applied as if the partnership were similar to a corporation.[126] Section 59A, however, does not include any language to specify that partnerships are to be treated as entities in calculating the BEAT. Moreover, treating partnerships as entities could inappropriately multiply gross receipts passing through members of a controlled group of corporations. In our view, treating a partnership

[123] H. Rep. 115-409, Act, at 400 (Nov. 13, 2017); Senate Finance Committee Explanation, 391 (Nov. 30, 2017); and note that Section 59A is the only section in the Part VII, subchapter A Chapter 1 of the Code, Base Erosion and Anti-Abuse Tax.

[124] *See* Treas. Reg. § 1.882-5(c)(4).

[125] Section 702 and Treas. Reg. § 1.702-1(a)(8)(ii).

[126] *See, e.g.*, the new Section 163(j) treating partnerships as entities in Section 163(j)(4).

as an aggregate of its partners for purposes of Section 59A and testing gross receipts, Base Erosion Percentage and Base Erosion Payments at the partner level (and not at the partnership level) seems consistent with the purpose of the statute. For administrability, consideration should be given to providing a de minimis exception to the aggregate approach for relatively small ownership interests (*e.g.*, 5-10%).

It is conceivable that taxpayers might attempt to utilize a partnership's special allocations to move particular income items or expense items to partners that would not be treated as related persons for purposes of Section 59A. We note that allocations must have substantial economic effect under Section 704(b), and partnerships must also satisfy the anti-abuse rule of Treas. Reg. § 1.701-2. We regard these existing defenses against abusive allocations as being sufficient for purposes of partnership allocations that may impact the BEAT.

L. **Conduits**

Section 59A(i)(1)(A) authorizes the Treasury Secretary to issue regulations or other guidance to prevent the avoidance of the purposes of Section 59A through the use of unrelated persons, conduit transactions, or other intermediaries. These mechanisms may allow taxpayers to avoid Section 59A by:

i. reducing average annual gross receipts to below the $500 million threshold;
ii. inflating the amount of allowable non-base erosion deductions to reduce its Base Erosion Percentage; or
iii. converting a payment from a Base Erosion Payment under Section 59A into a non-Base Erosion Payment.

1. Precedent Guidance

A taxpayer may engage an unrelated intermediary to turn what otherwise would have been a Base Erosion Payment to a related party into a deductible payment to the unrelated intermediary. That unrelated intermediary could then, through a separate arrangement, make a corresponding payment to the foreign person related to the original U.S. payor. One immediate source for anti-conduit rule precedent is the conduit financing rules of Treas. Reg. § 1.881-3 (the "**Conduit Financing Regulations**"). There are aspects of the Conduit Financing Regulations that are instructive but there are also a number of important differences between situations addressed by the Conduit Financing Regulations and those implicating the BEAT.

The Conduit Financing Regulations focus on financing transactions to manipulate treaty availability.[127] However, the potential use of a conduit to bypass Section 59A is not necessarily tied to the existence of a financing transaction. In addition, Base Erosion Payments include reinsurance payments and payments for depreciable property, neither of which is necessarily tied

127 *See Aiken Industries, Inc.*, 56 T.C. 925 (1971) and *Northern Indiana Public Service Co.*, 105 T.C. 341 (1995), aff'd, 115 F.3d 506 (7th Cir. 1997).

to financing transactions.[128] Further, while the Section 59A concern is focused on unrelated intermediate entities, the Conduit Financing Regulations focus on related parties but apply irrespective of the relationship between the parties to the financing arrangement.

In the Conduit Financing Regulations, conduit treatment is based on several factors that are not directly relevant to the Section 59A context. First, the Conduit Financing Regulations look to whether the entity is part of a plan to reduce the amount of tax imposed under Section 881. That relatively straightforward analysis could be appropriate in the context of a gross-basis tax, such as that imposed on fixed or determinable, annual or periodical income. However, in the Section 59A context, the tax is imposed on the payor, and the occurrence of an actual discernible tax liability of the payor could depend on several factors, including its profitability and the deductibility of the payment. Consequently, future regulations under Section 59A should look to whether a payment was converted from a Base Erosion Payment to a non-Base Erosion Payment rather than the amount of tax actually saved.

In the Conduit Financing Regulations, the conduit transaction must be pursuant to a tax avoidance plan. Given that future Section 59A regulations addressing the use of intermediaries to avoid the BEAT would necessarily be targeted at unrelated-party transactions, it could be difficult to effectively police the existence of a tax avoidance plan. The Conduit Financing Regulations mention several factors to identify a tax avoidance plan, some of which would not be present in BEAT-avoidance planning. For example, one factor is whether the intermediate entity can be expected to make payments under the financing transaction out of the business's cash flow, absent a transfer of money or other property by the financing entity. If the factor exists, the arrangement is presumed not to constitute a conduit financing arrangement, although the presumption is rebuttable. In the Section 59A context, however, such a presumption would likely be inappropriate because it is foreseeable that in an unrelated-party context, the intermediary could be more than sufficiently funded on its own. The Conduit Financing Regulations also refer to a "time period between financing transactions element." This factor would be less relevant where the goal is to attain a full deduction through an unrelated party payment without regarding to timing.

Given the above shortcomings of the Conduit Financing Regulations, Treasury may want to consider an approach that looks to whether an unrelated party that receives a deductible payment from a U.S. payor has a corresponding payable or liability to a party related to the original payor. The amount paid to the unrelated party could be considered a Base Erosion Payment to the extent of any corresponding payables or liabilities that the unrelated party has to the U.S. payor's foreign affiliate. Treasury would need to examine standards for when a deductible payment made by a U.S. payor and a payable or liability of an unrelated party should be viewed as "corresponding."

The "but for" standard in the Conduit Financing Regulations could be considered in this anti-abuse guidance. Under that standard, in order for an entity to be a conduit in a financing arrangement, the regulations require that the intermediate entity would not have participated in the

[128] For this purpose, anti-conduit regulations may look to Notice 2008-111, 2008-2 C.B. 1299, Notice 2004-20, 2004-11 I.R.B. 608, Notice 2001-16, 2001-1 C.B. 730, and other guidance regarding "midco" or "intermediary" transactions as a source for guidance on how sales based transaction could be regarded as a kind of conduit transaction.

financing arrangement on substantially the same terms ***but for*** the fact that the financing entity engaged in the financing transaction with the intermediate entity.[129] The Conduit Financing Regulations apply the "but for" standard to the taxpayer's specific facts and circumstances, meaning that the resulting outcome is necessarily difficult to predict, and its application can be challenging to police. Accordingly, the rebuttable presumption notion described below (and focused on the avoidance purpose of the arrangement) could be a potential measure to explore as a way to enhance the "but for" standard.

The Treasury may consider providing that an unrelated-party payment that has the appropriate characteristics is itself a Base Erosion Payment, rather than giving the Internal Revenue Service the authority to disregard the intermediate entity. An approach that simply reclassifies the payment as a Base Erosion Payment could eliminate the uncertainties present in the Conduit Financing Regulations context regarding what it means to disregard a conduit entity. In addition, the objective of Section 59A is not focused on the appropriate taxation of the payment in the hands of the rightful recipient and instead is focused on identifying Base Erosion Payments that should not be deductible.

One preliminary question is whether the regulations in this area should include a "tax avoidance plan" or "principal purpose" component. On the one hand, it makes sense to require that there be an affirmative attempt at tax avoidance before construing the statute broadly to impose a limit on tax benefits because taxpayers that are not looking to circumvent the statute should not be penalized. However, introducing a subjective element to the analysis is complex and may lead Treasury to conclude a more formalistic approach that does not require an investigation into a taxpayer's tax avoidance plan or purpose is preferable.

Treasury may consider a rebuttable presumption approach such that whenever a party that received a deductible payment from an unrelated U.S. payor makes a payment to a foreign party related to the original U.S. payor, a plan of tax avoidance is presumed.[130] This approach may be accompanied by a self-reporting requirement, whereby a taxpayer would need to report on an appropriate Internal Revenue Service form that, to the best of its knowledge, no unrelated party receiving an otherwise base eroding payment has a corresponding liability to a related party. The appropriate standard of knowledge may be considered so as not to overly encumber U.S. taxpayers with an obligation to diligence all of the receivables or assets of their related parties.

Similar to the Conduit Financing Regulations, any Section 59A anti-conduit regulations should include a provision addressing the use of multiple entities so that if a payee unrelated party has a payable to a second unrelated party, the IRS may continue to follow the chain until it finds a payable to a party related to the original U.S. payor. The rebuttable presumption approach could

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[129] Treas. Reg. § 1.881-3(a)(4)(i)(C).

[130] Examples of such a rebuttable presumption of a tax avoidance purpose can be found in Section 533(b), which states that "the fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders," and Temp. Treas. Reg. § 1.367(d)-1T(g)(6), which provides that "a U.S. person shall be presumed to have transferred intangible property for a principal purpose of avoiding the effect of section 367(d) if the property is transferred to the domestic corporation less than two years prior to the transfer of the stock of that domestic corporation to a foreign corporation."

potentially be useful here, as it would allow taxpayers to show that in coincidental circumstances, no plan of avoidance existed, and the payment should not be considered base eroding.

2. Exception for Certain Conduit Arrangements

Another question for Treasury to consider is the possibility of eliminating the application of Section 59A for certain transactions that are effectively conduit transactions, even between related parties. For example, if a U.S. person simply acts as a waystation for transactions between two foreign related parties or between an unrelated U.S. person and a related foreign person, the U.S. intermediary should arguably be outside the scope of Section 59A. Similarly, a foreign person can simply be an intermediary, either between U.S. companies or between a related U.S. company and a foreign unrelated company. We suggest that the regulations provide that where: (1) a U.S. taxpayer recognizes income and has a corresponding deductible payment, (2) the amount of the payment is materially equivalent to the amount of income recognized, and (3) the taxpayer bears no material economic exposure (as opposed to legal exposure) from the transaction, then the deductible payment should not be considered a Base Erosion Payment for purposes of Section 59A. In this context, the "but for" standard could be considered as well, perhaps by requiring the taxpayer to show that the deductible payment would not be made "but for" the corresponding item of income and vice versa.

M. <u>Modified Taxable Income</u>

The Base Erosion Minimum Tax Amount is the excess, if any, of (i) the Specified Percentage of Modified Taxable Income over (ii) regular tax liability reduced by certain tax credits as set forth in Section 59A(b)(1)(B).[131] Accordingly, the higher the Modified Taxable Income, the greater the BEAT, assuming that the amount described in clause (i) of the prior sentence exceeds the amount described in (ii).

Modified Taxable Income is defined for these purposes as "taxable income . . . determined without regard to" (i) any Base Erosion Tax Benefit or (ii) "the base erosion percentage of any net operating loss deduction allowed under Section 172 for the taxable year" ((i) and (ii), collectively, the "**BEAT Deductions**").[132] The appropriate interpretation of the phrase "taxable income . . . determined without regard to" is unclear. One interpretation would determine Modified Taxable Income by merely adding back to taxable income the BEAT Deductions (the "**Top-Up Approach**"). Another interpretation would determine Modified Taxable Income by recalculating taxable income as though the BEAT Deductions did not exist (the "**Recalculation Approach**"). Which approach is adopted can have a significant impact on both the complexity and amount of the BEAT. In general, the Top-Up Approach is likely to result in less complexity and, in many cases, a greater BEAT liability as compared to the Recalculation Approach.

The Recalculation Approach may result in a lesser BEAT liability because once taxable income is modified to disregard the BEAT Deductions, a greater amount of certain deductions may

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[131] Section 59A(b)(1).

[132] Section 59A(c).

be utilized. This arises because for purposes of determining taxable income, the deductibility of many items (including NOLs, interest expense under Section 163(j) and charitable donations) is limited to a percentage of taxable income, with certain alterations. For example, under the Recalculation Approach, the increase in taxable income resulting from ignoring the BEAT Deductions will in turn result in an increased NOL utilization (assuming the existence of NOLs sufficient to offset all or a portion of such additional income). Similarly, if the Recalculation Approach is applied and the BEAT Deductions are disregarded, thereby increasing adjusted taxable income for purposes of Section 163(j), then more interest would be deductible under Section 163(j). Said another way, recalculating taxable income without BEAT Deductions frees up NOLs and Section 163(j) interest deductions, partially or fully offsetting the increase to taxable income from the exclusion of BEAT Deductions. This result does not occur if a Top-Up Approach is employed because under the Top-Up Approach, the cap on the amount of NOL deduction or interest deduction is static as opposed to dynamic (*i.e.*, deduction amounts do not increase when taxable income increases, notwithstanding that such deduction amounts are limited by a certain percentage of taxable income). Other similar effects may exist under other provisions of the Code.

To illustrate the above concept, consider the following example. In 2019, a U.S. corporation with $300 of gross income and $70 of deductions, which includes $50 in Base Erosion Tax Benefits, has an NOL that is at least $40 in excess of its capacity to use the NOL for regular tax purposes and the NOL has a Base Erosion Percentage of zero.

Example 1

	Recalculation Approach	*Top-Up Approach*
Gross income	$300	$300
Deductions	(70)	(70)
NOL (80%)	(184)	(184)
Taxable income	46	46
Base Erosion Payments	50	50
Increased NOL	(40)	- 0 -
Modified Taxable Income	$56	$96
10% of MTI[133]	$5.60	$9.60

Similarly, consider the following example of increasing interest deductions, otherwise limited by Section 163(j). All the facts are the same as in the first example above, except that

[133] As noted above, the BEAT tax payable for 2019 is the excess, if any, of 10 percent of Modified Taxable Income over regular tax liability reduced by certain credits. These calculations are designed merely to demonstrate the impact on Modified Taxable Income of the Recalculation Approach versus the Top-Up Approach.

instead of an NOL the corporation has interest expense of $100 to unrelated persons, of which $69 is deductible under Section 163(j).

Example 2

	Recalculation Approach	*Top-Up Approach*
Gross income	$300	$300
Deductions	(70)	(70)
Interest	(69)	(69)
Taxable income	161	161
Base Erosion Payments	50	50
Increased Section 163(j) Limit	(15)	- 0 -
Modified Taxable Income	$196	$211
BEAT at 10%	$1.96	$2.11

In each example, recalculating taxable income with attendant NOL and Section 163(j) adjustments occasioned by ignoring BEAT Deductions (*i.e.*, the Recalculation Approach) instead of simply adding back the BEAT Deductions to taxable income (*i.e.*, the Top-Up Approach) comparatively decreases Modified Taxable Income and thus decreases the BEAT if the taxpayer is otherwise subject to the BEAT.

As a policy and conceptual matter, we believe that the Recalculation Approach is an appealing approach because only with a true "with and without" calculation can the base erosion impact be measured. Allowing dynamic redeterminations of deductions that are derivative of taxable income seems appropriate (and base erosion would continue to be addressed because such increased deductions would still be subject to disallowance to the extent they are Base Erosion Tax Benefits). A "pure" Recalculation Approach would entail a parallel system for calculating Modified Taxable Income, however, similar to the corporate alternative minimum tax that was repealed by the Act. Also, as discussed below, to make the Recalculation Approach work properly, the role of NOLs would need to be considered.

The Recalculation Approach would generally allow NOLs to be used more rapidly for purposes of the Modified Taxable Income than for regular tax purposes, as in the case of Example 1 above. Once the NOL (reduced by its Base Erosion Percentage) has been fully used for Modified Taxable Income purposes, it would not be available for use in later years for purposes of calculating Modified Taxable Income even if there are remaining NOLs for regular tax purposes. For example, in Example 1, the $40 in additional NOLs that are used for purposes of calculating Modified Taxable Income would not be available for use in later years for Modified Taxable Income purposes, even though those NOLs would remain available for regular tax purposes. It should be noted that using NOLs on a more rapid basis for Modified Taxable Income purposes than for regular tax purposes would in some circumstances hurt rather than help taxpayers. For example, assume that a Year 1 NOL is not fully utilized for regular tax purposes in Year 2 but is fully absorbed in Year 2 for Modified Taxable Income purposes; if there would not be any BEAT liability in Year 2 even if the additional NOL was not used to reduce Modified Taxable Income, the taxpayer could end up with greater BEAT liability in Year 3 when there is no NOL left for Modified Taxable Income purposes. As a further example, assume that in Year 1 a taxpayer has $100 in gross income, $100 in non-base eroding deductions, and $100 in base eroding deductions. Thus, in Year 1 there is an NOL of $100 generated for regular tax purposes. In a pure Recalculation Approach pursuant to which there is a parallel system for the BEAT, the $100 of Base Erosion Tax Benefits in the loss year would not generate an NOL for BEAT purposes, leaving the taxpayer no NOL to carry forward for purposes of calculating future years' Modified Taxable Income. This would be inconsistent with Section 59A(c)(1)(B), which provides that Modified Taxable Income is determined without regard to the Base Erosion Percentage of the NOL (*i.e.*, 50% in this example, assuming that, as discussed in Part III.N below, Base Erosion Percentage is determined with reference to the year in which the loss arises rather than the year of utilization). It should also be noted that despite the general assumption that the Recalculation Approach would reduce the BEAT, if the NOLs are not allowed for Modified Taxable Income purposes, the BEAT could be inappropriately increased in subsequent years.[134]

The Recalculation Approach may be constructed to provide that a taxpayer does not look back and "remember" what the entity's hypothetical results would have been in prior years. Under this variation, the taxpayer simply starts with the NOLs it actually has available to it (for regular tax purposes) in the current year, disregards the Base Erosion Percentage of such NOLs, and uses the resulting amount of available NOLs in calculating Modified Taxable Income. For example, in Example 1, the $40 in additional NOLs that are used for purposes of calculating Modified Taxable Income would still be available for use in later years for Modified Taxable Income purposes because they were not utilized in determining regular taxable income. This could be viewed as providing a double benefit for the non-base eroding deductions because they reduce Modified Taxable Income in the loss year and remain available for utilization to reduce Modified Taxable Income in future years.[135]

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[134] Assuming that, as discussed below, under the Top-Up Approach Year 1 Modified Taxable Income is calculated by adding the $100 in base-eroding deductions to a starting point of negative $100 (rather than zero) in taxable income, the Year 1 NOL would be available in future years as a carryover for calculating Modified Taxable Income, subject to adding back the Base Erosion Percentage of 50 percent -- in effect, half the Year 1 NOL would be available for Modified Taxable Income purposes.

[135] *Compare* Rev. Rul. 66-374, 1966-2 C.B. 427, which attempts to isolate, in a consolidated group setting, the "the total tax which the 'hypothetical' tax of each member, if computed on a separate return, would bear to the total amount of the hypothetical taxes for all members of the group so computed". The ruling concludes that "[i]n computing the 'hypothetical' tax of a member, the amount of the net operating loss deduction of the member shall be the amount the net operating loss deduction would be if such member had actually filed a separate return for such taxable year. Thus, for example, a net operating loss deduction of a member used in computing its hypothetical tax on a separate return basis shall not include the portion of such member's loss sustained in a prior year which had been absorbed by the group or by the member in computing actual tax liabilities for prior years". Thus, if a member's NOL was utilized by the group in a prior year (for regular tax purposes), it is not available in the current year for determining the separate member's available NOL for its hypothetical separate tax liability, even if on a purely separate entity approach applied to all years, the NOL would not have been "used" in the prior

The statutory language of Section 59A(c)(1)(B)[136] might suggest that the NOLs taken into account in determining Modified Taxable Income are limited to the non-Base Erosion Percentage of NOLs that were actually allowed on the taxpayer's tax return (*i.e.*, a static number that is not recomputed for the increased income by reason of disregarding Base Erosion Tax Benefits). Such interpretation might further suggest that other deductions derivative of the amount of taxable income (*e.g.*, interest expense under Section 163(j) as discussed above) should similarly be static, not increasing by reason of increased income (*i.e.*, the Top-Up Approach).

If the Top-Up Approach is adopted, there is an issue as to how to calculate Modified Taxable Income if there is a loss in the year in question (*i.e.*, there is no taxable income). We believe that Modified Taxable Income is appropriately calculated by adding the Base Erosion Tax Benefits to the loss amount (*i.e.*, by essentially treating taxable income as a negative number in this case). If taxable income – the starting point for calculating Modified Taxable Income -- could not be less than zero, the add back of the Base Erosion Tax Benefits could create a BEAT liability even though all or a portion of the Base Erosion Tax Benefits did not give rise to any benefit to the taxpayer (for example, where the taxpayer would not have had taxable income even in the absence of the Base Erosion Tax Benefits). In the example where the taxpayer has $100 in gross income, $100 in non-base eroding deductions, and $100 in base-eroding deductions, we believe that Modified Taxable Income should be zero, rather than using a starting point of zero for taxable income (on the basis that taxable income cannot be less than zero), adding back the Base Erosion Tax Benefits, and arriving at Modified Taxable Income of $100. This could be viewed as providing a partial double benefit for the $100 in non-base eroding deductions because the full $100 in non-base eroding deductions reduce Modified Taxable Income in the loss year and there is $50 in NOL (after subtracting the Base Erosion Percentage) for utilization to reduce Modified Taxable Income in future years. On the other hand, if Modified Taxable Income were determined to be $100 in the loss year in this example, the taxpayer would be penalized twice for the same Base Erosion Payment – first by increasing Modified Taxable Income in the loss year and then by applying the Base Erosion Percentage to the NOL in later years. We believe this would be an inappropriate result and we recommend the regulations confirm this if the Top-Up Approach is adopted.

Looking at the statutory language, the relevant phrase in Section 59A(c)—"taxable income . . . determined without regard to" —would seem to lend itself to the Recalculation Approach.[137] Because Section 59A does not specify the specific items of additions and subtractions as in Section

year for separate tax liability purposes. We note that Rev. Rul. 66-374 does not allow a member's NOLs to be used more than once.

[136] Section 59A(c)(1)(B) states that Modified Taxable Income is determined without regard to "the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year."

[137] The meaning of determined "without regard to" as utilized in Modified Taxable Income might be informed by other places in the Code which use such language in similar calculations. Calculated or computed "without regard to" appears in over 200 places in the Code, and in each, the context may dictate unique applications of the language. Section 163(j) specifies, both before and after the Act, that adjusted taxable income is to be "computed without regard to … any deduction allowable for net interest expense," NOLs, and depreciation, among other things. Proposed regulations interpreting such language prescribe an extensive series of specific additions and subtractions for reaching adjusted taxable income. We do not regard Section 163(j) or any other section utilizing "without regard to" to be clearly analogous to the BEAT calculation. *See, e.g.*, Section 172, Section 381(c).

163(j), we find the words suggest more strongly the Recalculation Approach. Under this interpretation, the determination of Modified Taxable Income would operate much like the calculation of a tax indemnity in transactional tax practice, where the indemnity compares two tax returns, one with the indemnified item and one without. In addition, the Recalculation Approach would arguably more accurately reflect the actual benefit of the BEAT Deductions; it is hard to see why a taxpayer should be treated as having a greater benefit as a result of Base Erosion Payments than the result had such payments never been made. On the other hand, the Top-Up Approach is significantly less complex and does not present the same issues in harmonizing the language of Section 59A(c)(1)(B) regarding the Base Erosion Percentage of NOLs or determining the appropriate model for taking NOLs into account.

N. Net Operating Losses

Section 59A(c)(1)(B) states that Modified Taxable Income "means the taxable income of the taxpayer … for the taxable year, determined without regard to any base erosion tax benefit … or the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year."

This language raises the question of whether the Base Erosion Percentage of any NOL is determined with respect to the year of its origination or the year of its utilization. The statutory language might be read to mean that the latter "taxable year" modifies the words "Base Erosion Percentage", which would indicate that the percentage is determined by the year of utilization. Such a construction might have been worded as follows: "or without any net operating loss deduction allowed for the year to the extent of the Base Erosion Percentage for such year."

We believe the grammatically correct reading is that the latter "for the taxable year" modifies its nearest antecedent noun, "deduction", meaning that Modified Taxable Income for the year is calculated without the relevant amount of NOL deduction allowed for the same year. As read in this manner, the language does not necessarily say anything about the year in which the Base Erosion Percentage of such NOL is determined. This interpretation is supported by the fact that Section 59A(c)(4)(B) explicitly excludes the NOL deduction in the calculation of Base Erosion Percentage, suggesting that NOLs imported into the year have a different Base Erosion Percentage than the Base Erosion Percentage for the year of utilization. In addition, Section 172 permits a single deduction for the year of utilization, but that deduction might consist of loss carry forwards from more than one past year and a different year's losses might have different characteristics (*e.g.*, separate return limitation year limitations or Section 382 limitations). We believe that the statutory instructions to calculate Modified Taxable Income without the Base Erosion Percentage of any NOL deduction allowed under Section 172 for the taxable year could nonetheless refer to losses from different years with different Base Erosion Percentages. In the absence of literal clarity, we look to examples of the application of the provision to ascertain the meaning most consistent with its legislative purpose.

Consider one simple example. In Year 1 the taxpayer generates a loss entirely attributable to Base Erosion Payments that exceeds taxable income and such loss carries forward to Year 2 where the taxpayer has a zero Base Erosion Percentage. The deduction of such NOLs in Year 2 appears to be the utilization of the attribute that results in a Base Erosion Tax Benefit. But if the Base Erosion Percentage were determined by reference to the year of utilization, the taxpayer would add back none of such NOLs to Modified Taxable Income for purposes of calculating its Year 2 BEAT. That approach appears unjustified.

Similarly, if in Year 2 the taxpayer's Base Erosion Percentage were only 50 percent, carrying the Year 1 NOL forward to Year 2 and treating only 50 percent of such NOLs as base eroding would seem inconsistent with the notion that the NOLs were 100 percent base eroding in Year 1. Conversely, if the taxpayer's loss in Year 1 is entirely attributable to non-Base Erosion Payments, carrying such loss forward and using it in Year 2 (having a 50 percent Base Erosion Percentage) should not cause the NOLs to become attributable to Base Erosion Payments. That determination depends upon the circumstances in the year in which the loss was incurred. In general, to align with the BEAT's legislative purpose, it would seem that the Base Erosion Percentage of any NOL ought to be determined in the year when the expenses generating the loss are accrued. The alternative argument—that base erosion is limited to the tax benefit actually obtained and such benefit is determined in the year of utilization—does not seem to be an appropriate basis for characterizing what percentage of the NOLs represents Base Erosion Payments.

As a further issue, the statute does not clearly state whether to take into account an NOL from a year when the taxpayer did not meet the thresholds to be treated as an Applicable Taxpayer. Because the Base Erosion Percentage is calculated on a controlled group basis, one might assume that the failure to exceed the Applicable Taxpayer thresholds means there is no Base Erosion Percentage. On the other hand, a Base Erosion Percentage could be calculated under Section 59A(c)(4) for the actual taxpayer having such NOL even if it is not considered a part of an Applicable Taxpayer. Regulations should clarify whether taxpayers with NOLs from years not treated as subject to the BEAT have a Base Erosion Percentage.

A more difficult question arises in respect of NOLs carried forward from years prior to the effective date of the Act. With respect to the effective date of Section 59A, the Act provides that the amendments made by the Act "shall apply to base erosion payments (as defined in section 59A(d)…) paid or accrued in taxable years beginning after December 31, 2017".[138] Since the new statute only applies to payments paid or accrued in taxable years after 2017, it appears to have no impact on payments made prior to 2018 generating losses that carry forward as NOLs under Section 172. Such pre-effective date losses were utilizable in carryback or carryforward years under the rules then applicable including Sections 172 and 382.

Notwithstanding the language of the Act's effective date, Notice 2018-28[139], section 3 (relating to the application of the Section 163(j) limitation to applicable years after 2017) suggests a conclusion different from the treatment of pre-effective date NOLs based on the above interpretation of the statute. The Notice says that Treasury "intend[s] to issue regulations clarifying that taxpayers with disqualified interest disallowed under prior Section 163(j)(1)(A) for the last taxable year beginning before January 1, 2018, may carry such interest forward …" and that such "interest carried forward will be subject to potential disallowance under Section 163(j) as amended

[138] Act, Section 14401(e).

[139] Notice 2018-28, 2018-16 I.R.B. 492 ("**Notice**")

by the Act …”.[140] Finally, the Notice states that, “the regulations will provide that business interest carried forward from a taxable year beginning before January 1, 2018, will be subject to section 59A in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017…”.[141] However, this Notice relates to Section 163(j) interest carryforwards, which are “treated as interest paid or accrued in the succeeding taxable year.” The Notice does not specifically discuss the Base Erosion Percentage of NOLs. We question whether the approach in the Notice should apply to losses from payments that have been paid or accrued in pre-effective date tax years when they are carried forward as NOLs to a post-effective date tax year.

O. Section 163(j) Deferred Interest

Section 163(j) was amended by the Act to limit and defer the deductions of interest payments not only for those made to related parties but also for those made to any other party.[142] Section 59A provides rules for how to calculate Modified Taxable Income for interest payments in post-effective date tax years, stating that for purposes of determining Modified Taxable Income, “the reduction in the amount of interest for which a deduction is allowed by reason of [Section 163(j)] shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties.”[143] Thus, interest currently deductible under Section 163(j) is related party interest to the extent thereof. Because the provision maximizes the taxpayer’s allocable portion of currently deductible interest paid to related persons, the provision accelerates the application of the BEAT to such interest.[144]

However, the statute does not specify further how Section 163(j) deferred interest carryforwards are to be treated for BEAT purposes.[145] The ordering rule for the treatment of Section 163(j) interest is included in the Section 59A(c) rules for the calculation of Modified Taxable Income. Under this ordering rule, Section 163(j) carryforwards would be unrelated party interest first and then any related party interest remaining after the deduction in the year of original accrual. In all likelihood, such carryforward will frequently include both unrelated party interest and related party interest. This raises the question of how the Section 163(j) carryforward should be taken into account in calculating Modified Taxable Income.

While some simplification might be realized by treating Section 163(j) carryforwards in the same manner as NOLs, a Section 163(j) carryforward is not an NOL. Such deferred interest is

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140 Notice, section 3, para. 2.

141 Notice, section 3, para. 3.

142 Act, Section 13301. *See* New York State Bar Association Tax Section, Report No. 1393, *Report on Section 163(j)* (Mar. 28, 2018).

143 Section 59A(c)(3).

144 Note that Section 59A’s treatment of Section 163(j) allowed interest as related party interest and deferred interest as unrelated party interest is a reversal of the operation of pre-Act Section 163(j) that only applied to related party interest.

145 The Notice states that rules are to be issued as to the BEAT treatment of Section 163(j) interest carryforwards.

"treated as business interest paid or accrued in the succeeding taxable year."[146] As a result, Section 163(j) deferred interest is not subject to the 80 percent taxable income limitation or, in the case of pre-2018 NOLs, the carryforward expiration that Section 172 applies to NOLs.

The foregoing analysis suggests that in calculating Modified Taxable Income, Section 163(j) deferred interest should be treated as a Base Erosion Tax Benefit in the year allowable. Base Erosion Tax Benefits for this calculation is not tied to the Base Erosion Percentage of either the year of origination or utilization. Rather, the Base Erosion Tax Benefit is the amount paid or accrued to the related foreign person. Because of the special BEAT ordering rule for deferred interest, the amount of the Section 163(j) interest carryforward will be first unrelated party interest to the extent remaining from the origination year and then related party interest, if any, not deducted in the origination year. Thus to prevent double counting, each year's Section 163(j) deferred interest must carry its own related party percentage in order to calculate the Modified Taxable Income addition in the year of utilization. We assume that each different year's Section 163(j) deferrals will have unique related party percentages, and will be applied earliest year first.

One might ask whether Section 163(j) interest brought forward from years when the taxpayer did not exceed the Applicable Taxpayer threshold should be treated as a Base Erosion Payment. Under the statute, if a Section 163(j) deferral is treated as "paid or accrued" in the succeeding year when allowable, it would seem to be subject to BEAT in the year utilized to the extent of the related party percentage, whether or not the taxpayer was subject to BEAT in the year of origination.

Like NOLs, an issue arises when Section 163(j) deferred interest payments that were originally accrued in pre-effective date tax years produce a tax benefit in post-effective date years. Under the Notice (as discussed above), such deferrals are deemed to be paid or accrued in post-effective date tax years and such interest payments are subject to the BEAT regime. While the Section 163(j) statute says that deferred interest is treated as accrued in the later year, treating deferred interest as accrued in the succeeding year seems to be merely a calculation mechanic. The words of Section 163(j) do not indicate that such language is intended to be a general change to the accrual rules and, thus, the normal rules for the timing of payment or accrual would therefore continue to control the timing outside of Section 163(j). Under this interpretation, deferred interest under Section 163(j) actually paid or accrued before the effective date of Act would not be subject to BEAT when such deferred interest was allowable.

Applying BEAT differently to pre-Act deferrals under Section 163(j) seems sensible for some additional reasons. The pre-effective date Section 163(j) differs significantly from amended Section 163(j) and such differences may warrant different treatment for purposes of Section 59A. Old Section 163(j) applied strictly to interest payments made to related parties with a 50 percent relationship or to banks on debt guaranteed by such related parties, whereas new Section 163(j) applies to all interest payments regardless of relationship (eliminating the related-party rules it previously contained).[147] Section 59A imposes a 25 percent related-party rule to determine what

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[146] *See* Section 163(j)(2).

[147] *See* Act, Section 13301.

portion of Section 163(j) deferred interest is considered to be Base Erosion Payments.[148] Also the new Section 163(j) rules are applicable to bank interest guaranteed by a related person while Section 59A rules are not. If pre-effective date deferrals are subject to the BEAT, it would seem the related party first ordering rule applies, potentially making deferred interest unrelated party interest, in a manner directly at odds with pre-Act law.

Notwithstanding the Notice, to be consistent with the "year of origination" approach already literally prescribed by Section 59A and with our view on pre-effective date NOLs, pre-effective date interest payments should not be treated as Base Erosion Payments in years to which Section 59A applies.

148 Section 59A(g).