Report No. 1434
February 4, 2020

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 Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1434 – Report on Proposed and Final Section 59A Regulations*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1434 commenting on the proposed and final regulations issued in December 2019 under Internal Revenue Code Section 59A.

We commend the Internal Revenue Service and the Department of the Treasury for the thoughtful guidance issued under Section 59A. This Report comments mainly on issues relating to the proposed regulations. We have also commented on certain rules that are new to the final regulations, such as the expanded rules relating to the aggregate approach of the Base Erosion and Anti-Abuse Tax rules to partnerships.

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,

Andrew H. Braiterman
Chair

Enclosure

Cc:

Lafayette "Chip" G. Harter III
Deputy Assistant Secretary – International Tax Affairs
Department of the Treasury

Douglas Poms
International Tax Counsel
Department of the Treasury

Brett York
Associate International Tax Counsel
Department of the Treasury

Brenda Zent
Special Adviser
Department of the Treasury

Erika W. Nijenhuis
Senior Counsel
Department of the Treasury

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Anne Devereaux
Deputy Associate Chief Counsel (International)
Internal Revenue Service

Daniel McCall
Deputy Associate Chief Counsel (International – Technical)
Internal Revenue Service

Margaret O'Connor
Deputy Associate Chief Counsel (International)
Internal Revenue Service

John Merrick
Senior Level Counsel
Internal Revenue Service

Sheila Ramaswamy
Attorney-Advisor (Branch 5)
Internal Revenue Service

Azeka Abramoff
Attorney-Advisor (Branch 5)
Internal Revenue Service

Karen Walny
Attorney-Advisor (Branch 5)
Internal Revenue Service

Report No. 1434

New York State Bar Association Tax Section

REPORT ON PROPOSED AND FINAL SECTION 59A REGULATIONS
February 4, 2020

TABLE OF CONTENTS

I. Introduction **1**

II. Summary of Principal Recommendations **2**

A. Aggregate Group and Short Year Rules 2

B. Election to Waive Deductions 3

C. Corporate Transactions 4

D. Aggregate approach to partnerships 4

III. Detailed Discussion of Recommendations **5**

A. Aggregate group and short year rules 5

1. Aggregate group gross receipt and base erosion determinations 5
2. With-or-within rule 6
3. Members leaving or joining an aggregate group 7
4. Over- and under-counting situations 8
5. Cut-off time for leaving the aggregate group 9
6. Short tax year rules 10
7. Gross receipts rule for predecessors 10
8. Inbound transactions and predecessors 12
9. Consolidated group issues 12

B. Election to waive deductions 13

1. Reasons for waiver election 15
2. Waivers disregarded for certain purposes 16
3. Waiver of partnership deductions by a corporate partner 17
4. Election procedures 18
5. Partial waivers 18

C. Corporate transactions 19

D. Aggregate approach to partnerships 20

1. Comments on aggregate approach 21
2. ECI exception 22

3. Aggregate basis determination of base erosion payments and base erosion tax benefits for transfers of property 23

4. Small partner exception 30

New York State Bar Association Tax Section

<u>Report on Proposed and Final Section 59A Regulations</u>[1]

I. Introduction

This Report comments on the proposed regulations (the ***"Proposed Regulations"***)[2] and the final regulations (the ***"Final Regulations"***)[3] issued by the Department of the Treasury and the Internal Revenue Service (the ***"IRS"*** and together with the Department of the Treasury, ***"Treasury"***) on December 6, 2019 under Section 59A.[4] Section 59A imposes on each applicable taxpayer a tax equal to the base erosion minimum tax amount for the taxable year (the ***"Base Erosion and Anti-Abuse Tax"*** or ***"BEAT"***). This report follows our earlier Report No. 1409 (the "**2019 Report**")[5] submitted to Treasury on February 16, 2019 commenting on the proposed regulations (the ***"2018 Proposed Regulations"***)[6] issued on December 21, 2018, and our Report No.1397 (together with the 2019 Report, the ***"Prior Reports"***), submitted to Treasury on July 16, 2018 commenting on Section 59A.

This Report is not a comprehensive report on Section 59A and the Proposed and Final Regulations. We generally have not commented on issues relating to the Final Regulations, which in most respects follow the approach of the 2018 Proposed Regulations and which we commented on in the 2019 Report. We commend Treasury for its thoughtful consideration and responses to the comments that were submitted by ourselves and others on the 2018 Proposed Regulations, which are set out in detail in the

---

1 The principal author of this Report is Peter Schuur. The author would like to acknowledge the assistance of Lillian Aston, Cameron Rotblat and Robert Nelson-Sullivan in preparing this report. This report reflects comments and contributions from Kim Blanchard, Andy Braiterman, Robert Cassanos, Peter Connors, Andrew Herman, Robert Kantowitz, Kara Mungovan, Richard Nugent, Yaron Reich, Michael Schler, Eric Sloan and Joe Toce. This Report reflects solely the views 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-112607-19, 84 Fed. Reg. 67046 (Dec. 6, 2019).

3 REG–104259–18, 84 Fed. Reg. 66968 (Dec. 6, 2019).

4 Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended (the ***"Code"***).

5 New York State Bar Association Tax Section Report No. 1399, *Report on Proposed Section 59A Regulations* (Feb. 19, 2019).

6 REG–104259–18, 83 Fed. Reg. 65956 (Dec. 21, 2018).

Summary of Comments and Explanation of Revisions to the Final Regulations (the "***Explanation***").

Instead, this Report comments mainly on issues relating to the Proposed Regulations. However, we have commented on certain rules that are new to the Final Regulations, such as the expanded rules relating to the aggregate approach of the BEAT rules to partnerships.

Part II of this Report contains a summary of our recommendations. Part III contains a detailed discussion of our recommendations.

II. Summary of Principal Recommendations

A. Aggregate Group and Short Year Rules

1. In the context of members joining or leaving an aggregate group, we support the approach of the Proposed Regulations which allows taxpayers flexibility to choose between the pro rata or closing of the books method. However, we would also support a simplified approach that takes into account only full tax years of aggregate group members, and does not include a deemed year-end cut-off. If this alternative approach is adopted Treasury should consider adopting an anti-abuse rule that requires a deemed year-end if a sale or other transaction is arranged with a principal purpose of enabling a taxpayer to fall below the gross receipts or base erosion percentage thresholds.

2. If the regulations retain the deemed tax year-end rule, we recommend that Treasury adopt an annualization rule with respect to the gross receipts test so that taxpayers are not required to take into account more than 12 months of gross receipts of other group members in the context of changes in ownership involving corporations with different tax year ends.

3. If the regulations retain the deemed tax year-end rule, we recommend that with respect to the cut-off of the deemed year-end Treasury adopt the rules that apply to corporations that join or leave a consolidated group.

4. We support the rule in the Proposed Regulations that allows taxpayers to use any reasonable approach to address short tax years that does not over- or under-count and we do not believe that further guidance is needed to address short tax years.

5. We recommend that the predecessor rules take into account gross receipts of foreign predecessor corporations only to the extent the gross receipts are taken into account in determining income that is effectively connected with a U.S. trade or business of the predecessor corporation.

6. We recommend that the BEAT rules follow the general consolidated return principles applicable to intercompany transactions so that when a member corporation leaves a consolidated group, intercompany items that are taken into account under the rules for intercompany transactions are also taken into account for purposes of the BEAT gross receipts and base erosion percentage rules.

B. Election to Waive Deductions

1. We support the rule in the Proposed Regulations that allows taxpayers to elect to waive deductions for purposes of the BEAT because the waiver gives taxpayers some ability to mitigate the cliff effect relating to foreign tax credits that the 3% base erosion percentage threshold creates without engaging in workaround transactions, while imposing an appropriate cost in the form of the forgone deductions for doing so.

2. With respect to the application of the deduction waiver rules to consolidated groups, we recommend that Treasury clarify that for purposes of Treas. Reg. § 1.1502-32, waived deductions attributable to a consolidated group member are treated as nondeductible expenditures that decrease the tax basis in the member's stock.

3. We recommend that Treasury clarify that the election procedures in the Proposed Regulations can only be availed of if the waiver of a deduction, when taken together with any other relevant waiver elections, would take a taxpayer below the 3% base erosion threshold percentage.

4. We recommend that Treasury clarify that the BEAT waiver rules do not affect taxpayers' ability to claim or not to claim allowable deductions for general income tax purposes, which is beyond the scope of the BEAT rules.

5. We recommend that Treasury clarify that a corporate partner may elect to waive, in whole or in part, its allocable share of partnership deductions under the Proposed Regulations' waiver procedures. If waiver of partnership deductions is permitted, we recommend that the election to waive should be made by the corporate partner, after all income and deductions (prior to giving effect to such waiver) have been allocated among the partners and that waived deductions should be treated as non-deductible expenditures under Section 705(a)(2)(B).

6. We believe the election to waive deductions should be permitted at any point in the audit cycle (including after all other adjustments have been agreed upon). We also recommend that Treasury consider providing a streamlined procedure for electing to waive deductions in connection with examinations that would not require taxpayers to file amended returns.

C. Corporate Transactions

1. We support the general exclusion in the Final Regulations for transfers of stock in corporate nonrecognition transactions and distributions under Section 301 from the definition of base erosion payments, and Treasury should consider expanding the dividend exception to stock redemptions that are treated as distributions under Section 301.

D. Aggregate approach to partnerships

1. We support adding an ECI exception to the BEAT partnership rules. We recommend that the ECI exception should not be limited to the specific situations mentioned in the preamble to the Proposed Regulations, but should apply more broadly.

2. We recommend that Treasury consider providing guidance for calculating a partner's proportionate share of a partnership asset for partnerships that do not have pro rata sharing arrangements. We suggest that Treasury adopt a liquidation value approach, pursuant to which a partner's proportionate share of partnership property would be determined by assuming that the partnership sells each of its properties for their respective fair values on the determination date, allocates the gain or loss from the sale in accordance with the terms of the partnership agreement, and then distributes the proceeds to the partners in accordance with the distribution provisions of the partnership agreement.

3. We recommend that Treasury consider whether guidance is required for determining the amount of base erosion tax benefits arising from base erosion payments in situations where partnership profits and losses are not shared on a pro rata basis.

4. We recommend that Treasury clarify that base erosion tax benefits include curative allocations of an item of deduction attributable to a base erosion payment.

5. We support the rule in the Proposed Regulations that treats curative allocations of items of income away from a partner as base erosion tax benefits if they are substitutes for allocations of deductions from a base erosion payment.

6. For purposes of the small partner exception, constructive ownership rules limit downward attribution to corporations to circumstances in which a shareholder owns at least 50% of the corporation. We recommend that Treasury provide for a similar minimum ownership threshold for purposes of attributing ownership to a partnership from one of its partners.

7. We recommend that Treasury consider expanding the small partner exception to cover base erosion tax benefits attributable to all transactions with partnerships, including as a result of actual or deemed transfers of partnership property.

III. Detailed Discussion of Recommendations

A. Aggregate group and short year rules

The BEAT is imposed on an *applicable taxpayer*, which is a corporation (other than a RIC, REIT or S-corporation) with $500 million of gross receipts on average for the three prior taxable years[7] and a base erosion percentage of 3% or higher.[8]

Under the BEAT aggregation rules, a taxpayer that is a member of an aggregate group determines its gross receipts and base erosion percentage on the basis of the taxpayer's aggregate group.[9] For this purpose, transactions between members of the aggregate group (determined at the time of the transaction) are not taken into account. In the case of a foreign corporation that is a member of the aggregate group, only transactions that relate to income that is effectively connected with the conduct of a U.S. trade or business are not taken into account.[10]

The Final Regulations provide that an aggregate group is determined separately with respect to each taxpayer.[11] As a result, a taxpayer's aggregate group may be different than the aggregate group of another member of the taxpayer's group. These differences in aggregate groups can arise if members of an aggregate group have different tax years or if there are changes in the membership of an aggregate group.

1. Aggregate group gross receipt and base erosion determinations

---

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

8 Section 59A(e)(1)(C). If the taxpayer is a member of an affiliated group that includes a bank or registered securities dealer, the base erosion percentage test is satisfied if the taxpayer has a 2% or higher base erosion percentage. *Id*.

A taxpayer's base erosion percentage also is relevant for purposes of determining the amount of net operating loss deductions allowed under Section 172 that are added back in the calculation of the taxpayer's modified taxable income. The amount of the addback is the base erosion percentage of the net operating losses, determined using the base erosion percentage for the year in which the losses arose. Section 59A(c)(1)(B). Treas. Reg. § 1.59A-4(b)(2)(ii).

9 Treas. Reg. § 1.59A-2(c). An aggregate group is a controlled group of corporations as defined in Section 1563(a), subject to certain modifications, including that more than 50% (rather than at least 80%) common ownership by vote or value is required and foreign corporations are included only to the extent that such corporations have income that is effectively connected with the conduct of a trade or business in the United States or are otherwise subject to U.S. net income taxes under an applicable tax treaty. Treas. Reg. § 1.59A-1(b)(1).

10 *Id*.

11 Treas. Reg. § 1.59A-2(c)(2).

The Proposed Regulations provide guidance on technical issues that may arise in determining the gross receipts and base erosion percentage of an aggregate group, including rules for (i) situations when a member leaves or joins an aggregate group, for example in connection with M&A activity, (ii) taking into account short taxable years and (iii) taking into account items attributable to predecessors.

As we discuss below, the Proposed Regulations raise complicated questions as to how the gross receipts and base erosion tests should apply to aggregate groups, including issues relating to over- and under-counting of gross receipts, base erosion tax benefits and deductions, and whether the form of a transaction in which a corporation joins or leaves an aggregate group (stock sale, asset sale or tax-free reorganization) should change how items are counted for purposes of the aggregate group.[12]

As a general matter, we believe these rules will be significant only for taxpayers that are close to the gross receipts or base erosion percentage thresholds, and will not affect taxpayers that are over or under these thresholds by a wide margin. Also, we note that, in the case of the base erosion percentage test, the Proposed Regulations provide taxpayers the ability to use self-help by waiving deductions if a taxpayer crosses the base erosion percentage threshold, including as a result of any over-counting of items in connection with changes in the composition of the taxpayer's aggregate group. Accordingly, our recommendations below generally seek to address issues relating to aggregate group determinations without creating additional technical rules for concerns that may arise in particular situations.

2. With-or-within rule

The Final Regulations adopt a with-or-within rule for determining the gross receipts and base erosion percentage of a taxpayer's aggregate group. Under this rule, the taxpayer takes into account gross receipts, base erosion tax benefits, and deductions of each other member of the aggregate group for the tax year of such member that ends with or within the taxpayer's taxable year.[13] This rule changes the approach of the 2018 Proposed Regulations, which provided that each taxpayer would determine its gross receipts and base erosion percentage by reference to its own taxable year, taking into account the result of the other members of the aggregate group during that year.[14]

[12] Prop. Treas. Reg. § 1.59A-2(c)(4)-(6).

[13] Treas. Reg. § 1.59A-(2)(c)(3).

[14] *See* 84 Fed. Reg. 67047 (the purpose of the with-or-within rule is to avoid the administrative burden of treating all members of the aggregate group as having the same tax year as the taxpayer, which would require a pro forma determination for each member of the group that has a different tax year).

Since the Proposed Regulations treat a consolidated group as a single entity, the with-or-within rule is relevant only for aggregate group members that are not members of a consolidated group.[15]

3. Members leaving or joining an aggregate group

The Proposed Regulations provide that, for purposes of determining the gross receipts and base erosion percentage of a taxpayer's aggregate group, the taxpayer takes into account only the portion of another corporation's taxable year during which the corporation is a member of the aggregate group of the taxpayer.[16] When a member joins or leaves an aggregate group, the member is treated as having a deemed tax year-end immediately before joining or leaving.[17] The Proposed Regulations provide that a corporation that has a deemed year-end may allocate gross receipts, base erosion tax benefits and deductions through either a closing of the books or a pro rata allocation (other than for extraordinary items).[18]

The deemed year-end rule may require a number of different taxpayers to cut off tax years (using the pro rata or closing of the books method) in connection with acquisitions and other transactions where members join or leave an aggregate group.[19] For example, in the case of the sale of the shares of a target corporation from one group to another, a deemed year-end will be required for each member of the selling group and each member of the purchasing group (in order for the target corporation to determine the gross receipts and base erosion percentage of its aggregate group) and for the target corporation (for each member of the selling and purchasing groups to make its own aggregate group determinations). The deemed year-end rule thus will require a purchaser to obtain information regarding members of the selling aggregate group that the purchaser does not acquire. This information is not ordinarily shared by unrelated purchasers and sellers.

---

15 Treas. Reg. § 1.1502-59A(b)(2).

16 Prop. Treas. Reg. § 1.59A-2(c)(4).

17 *Id*.

18 *Id*. The Proposed Regulations define extraordinary items by reference to Treas. Reg. § 1.1502-76(b).

19 A change in ownership of a taxpayer does not cause the taxpayer to leave its own aggregate group. Instead, each member of the pre-change aggregate group that is no longer a member following the ownership change is treated as leaving the taxpayer's aggregate group, and each member of the post-change aggregate group that was not a member before the ownership change is treated as joining the taxpayer's aggregate group. Prop. Treas. Reg. § 1.59A-2(c)(2)(ii).

Thus, while we support the Proposed Regulations' approach to the deemed year-end rule, which allows taxpayers flexibility to choose between the pro rata or closing of the books method, we would also support a simplified approach that takes into account only full tax years of aggregate group members, and does not include a deemed year-end cut-off.

We recognize that this alternative approach would allow a taxpayer to ignore gross receipts, base erosion payments and deductions of aggregate group members that leave the taxpayer's aggregate group during the member's tax year, and would require taxpayers to pick up a full year of such items for members that join the group in such circumstances, rather than a partial year as under the deemed year-end approach.[20] It may be appropriate to backstop a no cut-off rule with an anti-abuse rule that requires a deemed year-end if a sale or other transaction is arranged with a principal purpose of enabling a taxpayer to fall below the gross receipts or base erosion percentage thresholds.

4. Over- and under-counting situations

The deemed year-end rule is in tension with the entire tax year approach of the within-or-within rule and so may create over-counting if a change in ownership involves corporations with different tax year ends.

Example 1

> Taxpayer has a calendar tax year. On November 30, 2020, DS, a 6/30 tax year-end corporation, leaves taxpayer's aggregate group.
>
> Under the with-or-within rule, it appears that, in 2020 taxpayer would take into account DS's full tax year ended 6/30/20 and, based on the deemed year-end rule, the short tax year 7/1/20 through 11/30/20, because both the full year and the partial year end with or within taxpayer's 2020 tax year.
>
> As a result, it appears taxpayer would take into account 17 months of DS's gross receipts, base erosion tax benefits and deductions in applying the gross receipts and base erosion percentage tests.

If the final regulations retain the deemed year-end rule, we believe that an annualization rule would be appropriate with respect to the gross receipts test, so that taxpayers are not required to take into account more than 12 months of gross receipts of

20 Taxpayers would continue to maintain the gross receipts history associated with their prior aggregate groups for prior tax years, since these amounts would have been tracked in any event for purposes of prior-year BEAT determinations.

other group members in the circumstances described above. An annualization rule may also be appropriate for the base erosion percentage test, to avoid over-weighting base erosion tax benefits and deductions in these circumstances, which may be helpful or harmful to a taxpayer depending on the composition of the base erosion payments and deductions for the relevant period.

Another way to address over-counting in this situation would be to include the partial year in the taxpayer's tax year that ends *following* the sale. Under the facts of Example 1, the taxpayer would include DS's partial year 7/1/20 through 11/30/2020 in taxpayer's 2021 tax year. As a result, the taxpayer would take into account DS's gross receipts in the same tax year in which the gross receipts would have been included had the sale not occurred. This approach does not require annualization.

We note that over-counting would not arise in this situation under the simplified no-deemed-year-end approach described in A.3, above. Under this approach, the taxpayer in Example 1 would take into account only DS's tax year ended 6/30/20. If DS joins a new group, each taxpayer in the new group would take into account DS's full 6/30/21 tax year (including the portion of the year between 7/1 and 11/30/20) under the regular with-or-within rule.

5. Cut-off time for leaving the aggregate group

The Proposed Regulations do not have a specific rule that says what time of day a deemed year-end occurs. However, an example in the Proposed Regulations suggests that the cut-off should occur at the time the relevant change in share ownership is effective from a legal perspective.[21] We recommend that the regulations adopt the rules that apply to corporations that join or leave a consolidated group by cross-reference to Treas. Reg. § 1.1502-76(b). This approach has the advantage of aligning the rules for a member that leaves an aggregate group that is not a consolidated group with the cut-off rule that would apply to a corporation that leaves a consolidated group. Although the consolidated return rules have their own idiosyncrasies, we believe consistency with these rules is preferable to a rule that looks only to the intraday timing of transactions.

[21] Prop. Treas. Reg. § 1.59A-2(f)(2)(Example 2)(deemed tax year ends at noon, the time when the share sale occurred).

6. Short tax year rules

The Proposed Regulations prescribe an annualization rule for a taxpayer that has a short tax year.[22] This rule applies only to the taxpayer, and not to members of its aggregate group. The Proposed Regulations permit a taxpayer in this situation to use any reasonable approach to determine the gross receipts and base erosion percentage of its aggregate group and specify that a reasonable approach should not over- or under-count gross receipts, base erosion tax benefits and other deductions of the taxpayer's aggregate group.

For the reasons discussed in A.2, above, we support the Proposed Regulations' rule that allows taxpayers to use any reasonable approach that does not over- or under-count to address short tax years, and we do not believe that detailed guidance is needed to address short tax years.

We note that the with-or-within rule naturally takes into account a full taxable year of any aggregate group member that ends with or within the taxpayer's short year (if the aggregate group member is a member of the taxpayer's group during the full taxable year of such aggregate group member). As a result, under such a reasonable approach, to avoid overstating items of income and deductions, items from any full tax years of aggregate group members that end with or within the taxpayer's short year would not be annualized.

Under the with-or-within rule, a taxpayer with a short tax year also would not take into account any portion of the tax year of an aggregate group member that ends after the end of the short year. On the other hand, the following tax year, the taxpayer would take into account the full year of such group member, so that the group member's items would over time be reflected in the taxpayer's gross receipts and base erosion percentage determinations. Therefore, we do not believe this situation would ordinarily result in true undercounting and we believe that adding additional rules to address this situation, such as another deemed year-end rule, is not warranted.

7. Gross receipts rule for predecessors

The Proposed Regulations provide that for purposes of determining whether a taxpayer satisfies the three-year gross receipts test, any reference to a taxpayer includes a reference to the taxpayer's predecessor.[23] Under the Proposed Regulations, a predecessor includes the distributor or transferor corporation in a transaction described in Section 381(a) in which the taxpayer is the acquiring corporation.[24]

---

[22] Prop. Treas. Reg. § 1.59A-2(c)(5).

[23] *Id*.

[24] *Id*.

The Preamble to the Proposed Regulations requests comments on the appropriate method of taking into account predecessors for purposes of determining gross receipts of a taxpayer's aggregate group. We agree that a specific rule for predecessors is warranted. Absent a predecessor rule, a taxpayer could eliminate its gross receipts profile by merging or liquidating into another corporation. The same concerns are not present in taxable asset acquisitions or in stock acquisitions, which preserve the selling taxpayer's gross receipts profile.

We note that the proposed predecessor rule will cause economically similar acquisitive transactions to produce different outcomes under the gross receipts test, depending on whether the taxpayer is an acquiring corporation in a Section 381(a) transaction. The examples below illustrate these differences.

Example 2

> Taxpayer acquires target corporation's assets pursuant to a merger that qualifies as a reorganization under Section 368(a)(1)(A). Target is a predecessor of taxpayer and therefore taxpayer would include target's gross receipts in the taxpayer's gross receipts, presumably for the tax year in which the acquisition occurs and the two prior years.

Example 3

> Taxpayer acquires 100% of the shares of target corporation in a taxable transaction or pursuant to a reorganization under Section 368(a). Target is not a predecessor of taxpayer. Under the Proposed Regulations' deemed year-end rules, taxpayer takes into account target's gross receipts in taxpayer's aggregate group only for the post-closing portion of target's tax year, and does not take into account target's pre-closing gross receipts.

Under the facts of Example 2, a taxpayer with a small amount of gross receipts may become subject to the BEAT right away because it inherits target's gross receipts history. In contrast, in Example 3, the taxpayer does not inherit target's pre-closing gross receipts (target on the other hand, will retain its gross receipts history). Thus, following the stock acquisition, the taxpayer would continue to benefit from lower historic gross receipts for the period before target joined taxpayer's aggregate group.

Example 4

> Taxpayer acquires target corporation's assets (directly or by acquiring a disregarded subsidiary of seller) for cash. Under the Proposed Regulations, taxpayer does not take into account target's gross receipts for any period because target is not a predecessor of taxpayer under Section 381(a) and target is not a member of taxpayer's aggregate group.

The predecessor rule for gross receipts in the Proposed Regulations provides that a "taxpayer includes a reference to any predecessor."[25] Under the aggregation rules, a taxpayer that is a member of an aggregate group determines its gross receipts on the basis of the aggregate group.[26] While it is not entirely clear, it is possible to read these two rules together to require a taxpayer to take into account gross receipts of its predecessor and gross receipts of other members of the predecessor's aggregate group (since those gross receipts would have been taken into account by the predecessor in determining its gross receipts). We believe this interpretation is consistent with the purposes of the predecessor rules. As discussed below, the Proposed Regulations include a rule that prevents double counting, in the case of aggregate groups with overlapping members.

The Proposed Regulations include a rule that says that there is no double counting of gross receipts, base erosion tax benefits and deductions of any corporation that is a member of the aggregate group of both the taxpayer and its predecessor.[27] As drafted, the predecessor rule only applies for purposes of applying the gross receipts test. We believe that the limitation of the predecessor rule to the gross receipts test is intentional, and so it is not clear to us why the anti-double counting rule refers not only to gross receipts, but also to base erosion tax benefits and deductions.

8. Inbound transactions and predecessors

We recommend that the predecessor rules take into account gross receipts of foreign predecessor corporations only to the extent the gross receipts are taken into account in determining income that is effectively connected with a U.S. trade or business of the predecessor corporation. This exception would be consistent with the general exception for gross receipts of foreign corporations in the Final Regulations.[28]

9. Consolidated group issues

The Preamble to the Proposed Regulations requests comments on whether it is appropriate to continue to eliminate gross receipts resulting from intercompany transactions when a member deconsolidates and joins a different aggregate group.

The Final Regulations generally treat all members of a consolidated group as a single person.[29] This rule is consistent with the rules for intercompany transactions in the

---

25 Prop. Treas. Reg. § 1.59A-2(c)(6).

26 Treas. Reg. § 1.59A-2(c).

27 Treas. Reg. § 1.59A-2(b)(ii).

28 Treas. Reg. § 1.59A-2(d).

29 Treas. Reg. § 1.1502-59A(b)(2).

consolidated group regulations. More specifically, the intercompany transaction rules generally treat consolidated corporations as divisions of a single corporation for purposes of taking into account intercompany transactions.[30] Under the acceleration rule, intercompany items and corresponding items must be taken into account when one of the parties to the intercompany transaction leaves the group because such items can no longer be taken into account to produce the effect of treating the parties to the intercompany transaction as divisions of a single corporation.[31]

We recommend that the BEAT rules follow the general consolidated return principles applicable to intercompany transactions. When a member corporation leaves a consolidated group, intercompany items that are taken into account under the rules for intercompany transactions should also be taken into account for purposes of the BEAT gross receipts and base erosion percentage rules. However, if a corporation leaves a consolidated group but remains a member of the consolidated group's aggregate group, then such intercompany transactions would not be taken into account under the general rule for transactions between members of aggregate groups.[32]

Neither the Proposed Regulations nor the Final Regulations provide a rule for the treatment of the gross receipts of a corporation that joins a consolidated group (for example, in an M&A transaction). As noted above, the Final Regulations generally treat all members of a consolidated group as a single person. Under an asset acquisition approach, the consolidated group would not take into account the gross receipts for pre-consolidation years of a corporation that joins the group. Under this rule, a corporation's gross receipts history would disappear if it becomes a member of a consolidated group. In contrast, under a predecessor approach, the consolidated group would take into account the gross receipts history of the new member. It would be helpful for Treasury to clarify this point.

B. Election to waive deductions

For purposes of the BEAT, a taxpayer's base erosion percentage is computed by dividing the aggregate amount of base erosion tax benefits by the sum of the aggregate amount of deductions allowable plus certain other base erosion tax benefits.[33] Base erosion tax benefits include, among others, deductions allowed with respect to payments

---

30 Treas. Reg. § 1.1502-13(a)(6).

31 Treas. Reg. § 1.1502-13(d).

32 Treas. Reg. § 1.59A-2(c).

33 Section 59A(c)(4).

to a foreign related party as well as depreciation deductions allowed with respect to property acquired through such payments.[34]

As the Preamble to the Proposed Regulations notes, Section 59A defines base erosion tax benefits by reference to deductions that are *allowed* with respect to base erosion payments; however one category of base erosion payments consists of amounts paid or accrued by a taxpayer to a foreign related party with respect to which deductions are *allowable*.[35] The general explanation of the Joint Committee on Taxation similarly describes base erosion tax benefits by reference to deductions allowed and base erosion tax payments by reference to deductions that are allowable.[36] The various uses of "allowed" and "allowable" in the statute create ambiguity as to the proper treatment for purposes of the BEAT of deductions that a taxpayer declines to claim on its tax return, which the Proposed Regulations clarify.

The Proposed Regulations introduce a rule that allows a taxpayer to waive all or part of the deductions that could be claimed by a taxpayer for the taxable year.[37] This rule applies *solely for purposes of* the rules for determining base erosion tax benefits in Treas. Reg. § 1.59A-3(c)(1).

The waiver rule is intended to permit a taxpayer that satisfies the BEAT gross receipt test and has a base erosion percentage of 3% or higher (before taking into account the waiver) to waive deductions in order to take its base erosion percentage below the threshold. A taxpayer can be expected to waive deductions and therefore elect out of BEAT if the regular income tax (without BEAT) on its taxable income without regard to the waived deductions is less than the taxpayer's income tax (with BEAT) taking the waived deductions into account. Under the waiver rule, if the taxpayer waives the deduction by following a specific procedure in the Proposed Regulations, the deduction will not be treated as a base erosion tax benefit and will be waived for all U.S. federal income tax purposes (other than certain identified exceptions).[38]

The Proposed Regulations set out an exclusive approach for waiving deductions. Unless a taxpayer follows the procedures specified in the Proposed Regulations, an

---

[34] Section 59A(c)(2).

[35] 84 Fed. Reg. 67048. *Compare* 59A(d)(1) *with* 59A(c)(2).

[36] Staff of the Joint. Comm. on Tax'n, General Explanation of Public Law 115-97, (Dec. 20, 2018) JCS-1-18 at 402, 403.

[37] Prop. Treas. Reg. § 1.59A-3(c)(5).

[38] Prop. Treas. Reg. § 1.59A-3(c)(6). *See* discussion in Section B.2, below.

allowable deduction that is a base erosion tax benefit will be treated as a base erosion tax benefit, even if the taxpayer does not claim the deduction on its tax return.[39]

If two or more corporations in an aggregate group have different minority owners and the aggregate group is above the threshold base erosion percentage, complex dynamics may arise with respect to waiver elections. For example, if a corporation owns 51% of two U.S. subsidiary corporations, and the 49% shareholders are not related to one another, each subsidiary may prefer that the other subsidiary waive deductions to bring the aggregate group below the base erosion percentage threshold.

1. Reasons for waiver election

As the Preamble notes, the election to waive deductions will reduce the number of taxpayers that are subject to the BEAT and the overall amount of BEAT collected. The Preamble sets out a qualitative analysis that says that the waiver will reduce incentives for taxpayers who are near the BEAT thresholds to forgo additional U.S. business activity that would produce base erosion deductions, and will also reduce incentives for such taxpayers to implement business, contractual or accounting changes designed to avoid the application of the base erosion percentage test, including choosing to make deductible payments to unrelated parties rather than related parties.

We believe it is a close question whether the BEAT regulations should permit certain taxpayers to avoid paying BEAT by engaging in transactions with related foreign parties on a non-deductible basis, rather than forcing those taxpayers to engage in similar transactions with third parties or to forgo engaging in transactions altogether. As the Preamble notes, allowing taxpayers to engage in non-deductible transactions with related foreign parties may reduce the incentive for such taxpayers to substitute transactions with unrelated parties for those with foreign related parties and may encourage taxpayers to engage in additional transactions with foreign related parties that would otherwise be classified as base erosion payments. If the purpose of the 3% base erosion percentage threshold is to allow taxpayers that have a sufficiently low percentage of base erosion tax benefits to fall outside the BEAT, it may be appropriate to permit taxpayers to forego deductions and fall within the exception. On the balance, we support the waiver election because the waiver gives taxpayers some ability to mitigate the adverse effects of the BEAT rules, including cliff effects relating to foreign tax credits, without engaging in workaround transactions, while imposing an appropriate cost in the form of the forgone deductions for doing so.[40]

---

39 Prop. Treas. Reg. § 1.59A-3(c)(5).

40 *See* 84 Fed. Reg. 67052. As the example in the Preamble to the Proposed Regulations illustrates, the denial of the use of foreign tax credits creates a cliff effect with respect to BEAT liability. Certain taxpayers will prefer to waive deductions (and pay regular income tax without taking into account the otherwise deductible amounts but with reduction by foreign tax credits) rather than pay BEAT on such amounts with no foreign tax credit.

2. Waivers disregarded for certain purposes

The Proposed Regulations provide several exceptions to the general rule that deductions a taxpayer elects to waive for purposes of the BEAT are waived for all other U.S. federal income tax purposes. These exceptions include determining the taxpayer's method of accounting, allowable depreciation deductions, qualification for apportionment of research and experimentation deductions, transfer pricing and the amount of the taxpayer's earnings and profits.[41] If a taxpayer waives deductions with respect to depreciable property, the taxpayer's basis in such property nevertheless continues to be adjusted downward for depreciation.[42] The depreciation recapture rules of Section 1245 would appear to continue to apply to gain from the disposition of depreciable property with respect to which deductions have been waived. Thus, a taxpayer that waives deductions with respect to depreciable property may still be subject to ordinary income recapture of gain corresponding to the waived deduction, upon the sale of such property.

The Final Regulations provide that all members of a consolidated group are treated as a single taxpayer for purposes of determining applicability of the BEAT and the amount of tax due.[43] We suggest that Treasury consider clarifying that for purposes of Treas. Reg. § 1.1502-32, waived deductions attributable to a consolidated group member are treated as nondeductible expenditures that decrease the tax basis in the member's stock. Otherwise, a consolidated group may be able to subsequently benefit from a waived deduction by disposing of the stock of the subsidiary that generated the waived deduction for a smaller amount of gain (or greater loss).

It is not entirely clear how the *solely for purposes of* limitation in Prop. Treas. Reg. § 1.59A-3(c)(5) and (6) should be interpreted. As discussed above, it is clear that waived deductions are waived for all U.S. federal income tax purposes. We believe that the solely for purposes of limitation may be intended to say that the election procedures in the Proposed Regulations can only be availed of if the waiver of a deduction, when taken together with any waivers by other members of the taxpayer's aggregate group, would take a taxpayer below the 3% base erosion threshold percentage. That is, a taxpayer may not waive deductions under the special BEAT procedures if the waiver would not have this effect. We also believe that Treasury should clarify that the BEAT

---

41 Prop. Treas. Reg. § 1.59A-3(c)(6)(ii)(B). The Proposed Regulations also include a back-stop rule that disregards the waiver for purposes of determining any other item as necessary to prevent a taxpayer from subsequently receiving the benefit of such waived deduction. Prop. Treas. Reg. § 1.59A-3(c)(6)(ii)(B)(7).

42 Prop. Treas. Reg. § 1.59A-3(c)(6)(ii)(B)(3).

43 Treas. Reg. § 1.1502–59A(b).

waiver rules do not affect taxpayers' ability to claim or not to claim allowable deductions for general income tax purposes, which is beyond the scope of the BEAT rules.

3. Waiver of partnership deductions by a corporate partner

The Proposed Regulations provide that a taxpayer may elect to waive deductions that could be properly claimed by the taxpayer. Under Subchapter K of the Code, each partner in a partnership takes into account its distributive share of the partnership's items of income, gain, loss, deduction and credit. The Proposed Regulations are silent as to whether a corporate partner may elect to waive its allocable share of partnership deductions for purposes of the BEAT. Allowing a taxpayer to waive its allocable share of partnership deductions would be consistent with the treatment of partnerships as aggregates under the Final Regulations. Under these rules, a taxpayer's share of partnership deductions may be treated as base erosion tax benefits in a number of circumstances, including payments or accruals by a partnership to a foreign person who is related to the taxpayer and depreciation deductions attributable to assets of the partnership that are acquired or deemed to be acquired from related foreign persons.[44] We respectfully request that Treasury clarify that a corporate partner may elect to waive, in whole or in part, its allocable share of partnership deductions under the Proposed Regulations' waiver procedures.

If waiver of partnership deductions is permitted, the election to waive should be made by the corporate partner after all income and deductions (prior to giving effect to such waiver) have been allocated among the partners. In this way, the allocation of items of income and deductions among partners is not impacted by a partner's election to waive its share of partnership deductions. Additionally, if a waiver is allowed with respect to partnership items, waived deductions should be treated as non-deductible expenditures under Section 705(a)(2)(B). Otherwise a corporate partner may be able to subsequently benefit from partnership deductions it has waived by disposing of its interest in the partnership generating such deductions.

If a waiver of partnership deductions is permitted, the effect of a waiver will need to be reconciled with the partnership audit rules of the Bipartisan Budget Act of 2015. For example, a partner's distributive share of base erosion tax benefits may decrease as a result of an audit adjustment. If a partnership makes an election under Section 6226 to push out adjustments to its partners, a partner should be permitted to elect to waive any increase in its share of partnership deductions resulting from such adjustment without being required to submit an amended tax return. If an adjustment is made at the partnership level under Section 6225, it may be appropriate to allocate to a partner its share of any additional base erosion tax benefits. However, in these circumstances, the

---

[44] Treas. Reg. § 1.59A-7. *See* discussion in Section D, below.

partner should be permitted to elect to waive other allowable deductions (under the general waiver rules) to offset the effect of the additional base erosion tax benefits resulting from the partnership level adjustment.

4. Election procedures

The Proposed Regulations provide that a taxpayer may make an election to waive deductions on an annual basis, on its original filed federal income tax return.[45] The Proposed Regulations also provide flexible rules allowing a taxpayer to make an election to waive deductions or increase waived deductions in connection with amended returns or IRS examination. However, no reversal or reduction of previous waivers is permitted.[46] The Preamble to the Proposed Regulations requests comments on the process for submitting an election to waive deductions during the course of an examination.[47]

The Large Business and International Division of the IRS generally requires that a taxpayer make any informal claims for a refund in connection with an examination within 30 days of the opening of the conference.[48] Otherwise the taxpayer must submit an amended tax return to have the claim considered. However, in fairness to taxpayers, an election to waive deductions should be permitted at any point in the audit cycle. In light of the one-way ratchet rule for waivers, taxpayers should be allowed to waive deductions after all other adjustments have been agreed upon. Additionally, Treasury should consider providing streamlined procedures for electing to waive deductions in connection with examinations. A taxpayer should be able to make a waiver election in connection with an examination process without being required to file an amended return. Amending tax returns may be burdensome in some cases.

5. Partial waivers

The Proposed Regulations provide that, to elect to waive deductions, a taxpayer must provide information related to each deduction waived as required by applicable forms and instructions issued by the IRS, including a description of the item or property to which the deduction relates, the date on which or the period in which the waived deduction was accrued, the relevant provision of the Code and regulations (as applicable), the amount of deduction that is claimed and the amount of the deduction that is waived.[49]

---

45 Prop. Treas. Reg. § 1.59A-3(c)(6)(iii).

46 *Id.*

47 84 Fed. Reg. 67048.

48 *See, e.g.*, IRM 4.46.3.6.8, Claims Discussion and IRS Publication 5125, Large Business & International Examination Process.

49 Prop. Treas. Reg. § 1.59A-3(c)(6)(i).

These rules do not expressly refer to partial waivers of deductions. However, we understand that such partial waivers would be permitted because, in the rules regarding the effect of waiving deductions, the Proposed Regulations also refer to the "election to waive a deduction, in whole or in part."[50] It would be helpful if forms and instructions issued by the IRS provide clear procedures for partial waivers of deductions.

C. Corporate transactions

We commend Treasury for its approach to corporate transactions in the Final Regulations. We support the general exclusion for transfers of stock in corporate nonrecognition transactions (including exchanges described in Section 351, liquidations described in Section 332, reorganizations described in Section 368, and spin-offs described in Section 355) from the definition of base erosion payments in the Final Regulations. We also agree with the decision of Treasury not to extend this nonrecognition exception to other property ("boot") exchanged in a nonrecongnition transaction.

Consistent with the Preamble to the 2018 Proposed Regulations,[51] the Final Regulations provide that a taxpayer's receipt of depreciable property from a foreign related party as an in-kind distribution subject to Section 301 is not a base erosion payment because there is no consideration provided by the taxpayer to the foreign related party in exchange for the property.[52] Any distribution under Section 301, regardless of whether constituting a dividend under Section 301(c)(1), a return of capital under Section 301(c)(2) or gain under Section 301(c)(3), does not give rise to a base erosion payment. In contrast, this exception does not extend to redemption of stock by a corporation under Section 302 or an exchange of stock under Section 304, regardless of whether or not it is treated as a Section 301 distribution pursuant to Section 302(d).

The form-driven approach of the Final Regulations with respect to both Section 301(c)(3) gain and Section 302 and 304 dividends is unusual. The treatment of these distributions for purposes of the BEAT rules depends entirely on whether stock is exchanged in connection with the distribution. As a result, despite generally having the same treatment as Section 301 distributions for other tax purposes, Section 302 and 304 transactions are treated differently for purposes of the BEAT. It is particularly anomalous that Section 301 distributions and Section 302 redemptions that are treated as Section 301 distributions are treated differently for purposes of the BEAT rules, including in situations where they may otherwise be indistinguishable economically (*e.g.*, with respect

50 Prop. Treas. Reg. § 1.59A-3(c)(6)(iii).

51 83 Fed. Reg. 65960.

52 Treas. Reg. § 1.59A–3(b)(2)(ii).

to a corporation with a single shareholder). We note that the choice of whether or not to redeem stock in connection with a distribution may be driven by non-tax reasons such as regulatory or foreign law concerns. Treasury may wish to reconsider this particular distinction. However, we acknowledge that in the context of bootstrap transactions involving the distribution of assets out of a target corporation as part of a plan of sale, whether or not stock is redeemed in connection with the transaction will govern its tax consequences.[53]

D. Aggregate approach to partnerships

The 2018 Proposed Regulations included a general rule that BEAT determinations are made at the partner level, based on an aggregate approach to partnerships.[54] The 2018 Proposed Regulations also included a specific rule regarding the application of the aggregate approach to payments made by or to a partnership, but provided little additional guidance on how the aggregate approach to partnerships would work.[55]

The Final Regulations retain the aggregate approach to partnerships but expand considerably the specific rules regarding the application of the aggregate approach to transactions involving partnerships. As in the 2018 Proposed Regulations, the Final Regulations provide that any amount paid or accrued by or to a partnership is treated as paid or accrued by or to each partner based on the partner's distributive share of the item of deduction or income with respect to the relevant amount.[56] However, the Final Regulations add rules for transfers or acquisitions of property by a partnership; for transfers or issuances of partnership interests, whether by partners or by the partnership itself, including in connection with contributions of property under Section 721(a); and for increases in the tax basis of distributed partnership property, including under Sections 732(b) or 734(b), which are treated as newly acquired assets.[57]

The Final Regulations also add a broad definition for a *transfer of a partnership interest*, which includes a partnership's issuance of a partnership interest, a secondary sale of a partnership interest, a change in a partner's proportionate share of any partnership asset as a result of a contribution of property or services to a partnership, a distribution or a redemption, or any other transfer of a proportionate share of a

53 *See e.g.*, *Merrill Lynch & Co. v. Comm'r*, 120 TC 12 (2003) , aff'd, 386 F3d 464 (2d Cir. 2004); Rev. Rul. 77-226, 1977-2 CB 90; *Estate of Durkin v. Comm'r,* 99 TC 561 (1992).

54 Prop. Treas. Reg. § 1.59A-7(a).

55 Prop. Treas. Reg. § 1.59A-7(b).

56 Treas. Reg. § 1.59A-7(c)(1).

57 Treas. Reg. § 1.59A-7(c)(1)-(4).

partnership asset, whether by a partner or the partnership, including as a result of a deemed or actual sale or a capital shift.[58]

The Explanation to the Final Regulations says that Treasury did not adopt comments requesting an exception for nonrecognition transactions involving partnerships, and acknowledges that this approach is different from the exception in the Final Regulations for corporate transactions. The Explanation says that the adoption of a Section 721(a) exception to the BEAT rules could permit related parties to use a partnership to avoid a transaction that would be a base erosion payment if that transaction occurred directly among the partners, and notes that the general tax rules that apply to corporations are fundamentally different from those that apply to partnerships.[59]

Under the Final Regulations' approach to Section 721, if a partnership issues a partnership interest to a taxpayer in exchange for a contribution of property (including cash), the taxpayer is treated for purposes of the BEAT as exchanging a portion of the contributed property for a portion of the other partners' pre-contribution interests in the partnership's assets.[60] If a related foreign person is a partner, for purposes of determining whether the taxpayer has made a base erosion payment to the foreign partner, the taxpayer is deemed to exchange a portion of each contributed asset (equal to the foreign partner's proportionate share of such asset following the contribution) for a proportionate interest in each of the partnership's assets (equal to the taxpayer's increased proportionate share of such assets as a result of the contribution).[61] The Final Regulations provide that the taxpayer will have base erosion tax benefits – which the taxpayer will take into account into account in determining its modified taxable income – equal to the taxpayer's distributive share of any depreciation with respect to the taxpayer's proportionate share of the property that it is deemed to acquire from the related foreign partner.[62]

1. Comments on aggregate approach

As discussed in our Prior Reports, we believe that the aggregate approach to partnerships is consistent with the purposes of Section 59A. While our 2019 Report did not make a specific recommendation regarding partnership nonrecognition transactions, it

58 Treas. Reg. § 1.59A-7(c)(3)(iv). Transfers of a partnership asset (other than a partnership interest) to a person not acting in a partner capacity are not treated as transfers of partnership interests.

59 Explanation, pp. 138-139.

60 Treas. Reg. § 1.59A-7(c)(3)(iii), (g)(i)(Example 1). These rules are discussed in greater detail in Section 2(a), below.

61 *Id.*

62 *Id.*

recognizes Treasury's concerns and says that, to the extent 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.[63] Although this construct may be appropriate for addressing specific concerns regarding base erosion in connection with the BEAT rules, we caution against applying it more broadly outside of the BEAT. We believe the Final Regulations' approach to partnership nonrecognition transactions does not fit well within the general framework of Subchapter K. As discussed below, common partnership profit and loss sharing arrangements may raise complicated technical questions and may produce results that are not consistent with underlying aims of the BEAT rules, and that may be both favorable and unfavorable to taxpayers.

We also note that the aggregate approach of the Final Regulations limits considerably the relevance of Section 707(b) as it applies to determining whether a taxpayer has made a payment to a related party within the meaning of Section 59A(g).[64] In these circumstances, we believe it would be appropriate for Treasury to seek to identify particular circumstances where an override of regular Subchapter K principles may not be necessary.

2. ECI exception

The Preamble to the Proposed Regulations requests comments on whether a contribution of depreciable property by a foreign person to a partnership, a transfer of a partnership interest by a foreign person, or a distribution of depreciable property from a partnership with a foreign partner to a related U.S. person should be excluded from the definition of a base erosion payment to the extent that the foreign person would receive or be expected to receive allocations of income effectively connected with the conduct of a U.S. trade or business (*"ECI"*).[65]

We support adding an ECI exception to the BEAT partnership rules. A taxpayer should not be treated as making base erosion payments or as having base erosion tax

63 2019 Report, pp. 33-34.

64 A related party includes (i) any 25% owner of the taxpayer, by vote or value; (ii) a related party to the taxpayer or to its 25% owner within the meaning of Sections 267(b) or 707(b)(1) and (iii) a related party to the taxpayer within the meaning of Section 482. Sections 267(b) and 707(b) generally treat partnerships as entities and require more than 50% relatedness. In contrast, under the aggregate approach of the Final Regulations, a transaction with a partnership may be subject to the BEAT rules if a related person owns any interest in the partnership, unless the small partner exception applies.

65 84 Fed. Reg. 67049.

benefits to the extent that the related foreign person is subject to U.S. federal income tax on allocations of income from the partnership interest. We believe the ECI exception should not be limited to the specific situations mentioned in the preamble, but should apply more broadly. For example, if a taxpayer contributes property to a partnership in which a related foreign partner is a partner, and thereby is deemed to acquire the foreign partner's proportionate share of the partnership's depreciable property, the ECI exception should apply to the extent that income from the partnership is effectively connected with the conduct of a U.S. trade or business, even though the foreign partner did not contribute property to the partnership and the partnership did not distribute property.

3. Aggregate basis determination of base erosion payments and base erosion tax benefits for transfers of property

Under the Final Regulations, four main categories of transactions are expressly subject to aggregate treatment and can result in base erosion payments and base erosion tax benefits. We discuss these transactions below, together with issues relating to determining base erosion payments and base erosion tax benefits for partnerships that do not provide for pro rata sharing of profits and losses.

a) Transfers of property and partnership interests

When a partnership transfers property, the Final Regulations provide that each partner is treated as transferring its *proportionate share* of the property for purposes of determining whether there is a base erosion payment.[66] Similarly, if a partnership acquires property, each partner is treated as acquiring its proportionate share of the property acquired.

As discussed above, if a partnership issues a partnership interest in exchange for a contribution of property, the contributing partner is treated as exchanging a portion of the contributed property for a portion of the other partners' pre-contribution interests in the partnership's assets.[67] Thus, for purposes of determining whether a taxpayer has made a base erosion payment, the contributing partner is deemed to exchange a portion of each contributed asset (equal the other partners' proportionate share of such asset following the contribution) for a proportionate interest in each of the partnership's assets (equal to the partner's increased proportionate share of such assets as a result of the contribution).[68] Consistent with the rules on transfers of partnership property, the rules look to the reduction of each partner's proportionate share in each of the partnership

[66] Treas. Reg. § 1.59A-7(c)(2).

[67] Treas. Reg. § 1.59A-7(c)(3)(iii).

[68] Treas. Reg. § 1.59A-7(c)(3)(iii).

assets to determine the amount of the deemed transfer. A correlative rule applies to liabilities of the partnership and liabilities of the contributing partner.

A similar rule applies to a transfer of a partnership interest by a partner. The Final Regulations provide that a secondary transfer of a partnership interest is treated as a transfer to the transferee of the transferor's proportionate share of each of the partnership's assets and an assumption of the transferor's proportionate share of the partnership liabilities.[69] Accordingly, a taxpayer that acquires a partnership from a related foreign partner will be treated as purchasing a proportionate share of depreciable assets of the partnership from the foreign partner.

In each of the cases described above, we understand that the deemed transfer or acquisition of property is taken into account only for purposes of determining whether a taxpayer has made a base erosion payment.[70] In other words, these deemed transactions do not give rise to a taxable exchange or recognition event for general U.S. tax purposes if the transaction is otherwise not taxable.

b) Determining a partner's proportionate share of a partnership asset in connection with actual or deemed transfers of property

In each of the rules described in 2(a) above, for purposes of determining whether there has been a base erosion payment in connection with a transfer of property to or from a partnership or a transfer of a partnership interest, partners are treated as transferring or receiving their *proportionate share* of the property.[71] The Final Regulations do not prescribe a method for calculating a partner's proportionate share of partnership property, and the examples in the Final Regulations address partnerships that have pro rata sharing arrangements. Thus, the Final Regulations do not provide guidance for partnerships that have varying sharing percentages for profits and losses, including as a result of layered allocations of profits and losses, preferred returns and hurdle arrangements, or that have varying loss sharing attributable to preferred and subordinated capital, or reversals of prior layered profits allocations.

As discussed in the examples in 2(c) below, even common partnership profit and loss sharing arrangements may give rise to difficult questions on how to determine base erosion payments. Accordingly, we recommend that Treasury consider providing

---

69 Treas. Reg. § 1.59A-7(c)(3)(ii).

70 *See* Treas. Reg. § 1.59A-7(a)("The aggregate principle in this section does not override the treatment of partnership items under any Code section other than Section 59A.").

71 Treas. Reg. § 1.59A-7(c)(2) & (3).

guidance for calculating a partner's proportionate share of a partnership asset for partnerships that do not have pro rata sharing arrangements.

One alternative would be to measure a partner's proportionate share by reference to the partner's distributive share of income or deductions from the property, similar to the principles that apply to payments made to or by the partnership.[72] For example, a partner's proportionate share of property that generates depreciation deductions would be determined based on the partner's distributive share of the depreciation deductions. Unless the determination takes into account expected future depreciation deductions with respect to the property (based on assumptions regarding future allocations), this rule may produce significant distortions if partners' shares of depreciation vary from year to year.

For this reason, we prefer a liquidation value approach, pursuant to which a partner's proportionate share of partnership property would be determined by assuming that the partnership sells each of its properties for their respective fair values on the determination date, allocates the gain or loss from the sale in accordance with the terms of the partnership agreement, and then distributes the proceeds to the partners in accordance with the distribution provisions of the partnership agreement. Under this approach, each partner would be treated as owning a ratable share of each item of partnership property based on its ratable share of the deemed distribution of the proceeds. We note that a liquidation value approach may not appropriately take into account partnership sharing arrangements involving special allocations of income and loss relating to particular partnership properties, which may need to be segregated.

c) Determining base erosion tax benefits

The Final Regulations provide that a partner's base erosion tax benefit is the partner's distributive share of any deduction or reduction in gross receipts attributable to a base erosion payment.[73] This includes a partner's distributive share of deductions under Section 704(b) and (c), as well as items of deductions that are not included in a partner's distributive share but that are attributable to adjustments under Sections 732, 734 and 743, among others.[74]

As illustrated by the examples below, the distributive share rule in the Final Regulations may lead to anomalous results, even in relatively common partnership profit and loss allocation patterns.

---

72 *See* Treas. Reg. § 1.59A-2(c)(1).

73 Treas. Reg. § 1.59A-7(d)(1).

74 Treas. Reg. § 1.59A-7(d)(1).

Example 6: Determining Base Erosion Tax Benefits in Non-Pro Rata Situations -- Preferred Capital and Preferred Return

PRS acquires Asset A from FP, a foreign person that is related to partner DC, for 100. Asset A is depreciable over 5 years, on a straight line basis. DC and unrelated partner UC each contributed 500 to PRS; however, DC has preferred capital and is entitled to a preferred return of 100% of partnership profits until DC has been allocated net profits equal to 10% of its investment. Thereafter, profits are shared 40% by DC and 60% by UC. DC's only other asset is 900 of non-depreciable property. Assume that these economic arrangements were not put in place with a principal purpose of avoiding a base erosion payment.

Fact Pattern 1: PRS has no net profits. In this situation, 100% of the depreciation deductions from Asset A will be allocated to UC because UC's capital is junior to DC's capital. Although it appears that there would be a base erosion payment with respect to Asset A, DC will have no base erosion tax benefits because no depreciation deductions attributable to Asset A are allocated to DC.

Fact Pattern 2: PRS has net profits in each period during Asset A's depreciable life, but the net profits are not sufficient to clear DC's preferred return. In this situation, 100% of the net profits (including the depreciation deductions) would be allocated to DC, and DC will have 100 of base erosion tax benefits. Note that the Final Regulations expressly permit DC to have base erosion tax benefits in excess of the related base erosion payment (which may have been less than 100).[75]

Fact Pattern 3: In year 1, PRS has net profits in an amount sufficient to satisfy DC's preferred return. Thereafter, PRS continues to generate net profits. In this situation, DC will have 20 of base erosion tax benefits in year 1, representing one year of depreciation from Asset A. The remaining 80 of depreciation from Asset A will be shared by DC and UC on a 40/60 basis. Therefore, DC will have 32 of additional base erosion tax benefits during years 2 through 5 and 52 of base erosion tax benefits in the aggregate.

Similar issues may arise in connection with other acquisitions and sales of property by a partnership.

Example 7: Partner Contributes Asset to Partnership

---

[75] Treas. Reg. § 1.59A-7(d)(1).

FC contributes Property A to PRS in exchange for a partnership interest. FC is related to DC, a partner in PRS.

DC is treated as acquiring its proportionate share of Property A (and DC is treated as transferring a portion of its proportionate share of each of PRS's assets to FC). The base erosion payment is the deemed payment from DC to FC. The base erosion tax benefit is the amount of depreciation allocated to DC with respect to Property A.

Example 8: Partnership Sells Asset to Related Partner

PRS sells a depreciable asset to DC, a domestic corporation that is related to foreign partner FC. In this case, the Final Regulations provide that DC is treated as acquiring FC's proportionate share of the asset from PRS. The base erosion payment is the payment to PRS for FC's proportionate share of the asset, and the base erosion tax benefit is the depreciation deductions that DC enjoys from FC's proportionate share of the asset.[76]

In Examples 7 and 8, it may not be clear how to determine the amount of the base erosion payment if the partnership does not provide for pro rata sharing of profits and losses.[77] And similar to Example 6, base erosion tax benefits may vary in a way that does not correspond to particular assets of the partnership, for example, if one of the partners has preferred capital, or if the partnership provides for separate layers of profit and loss allocations.

The results shown in the examples generally should not be present in transactions involving secondary sales of partnership interests, where the purchasing partner steps into the shoes of the depreciation deductions of the selling partner.

Example 9: Sale of Partnership Interests

FP, a foreign person, holds an interest in partnership PRS, which owns depreciable property. FP sells its partnership interest to DC, a related U.S. corporation.

Under the Final Regulations, the transaction is treated as if FP had transferred its proportionate share of the assets of the partnership, including the depreciable property, the base erosion payment is equal to the portion of the purchase price (including the share of partnership liabilities) attributable to the depreciable assets, and the base erosion tax

---

76 Treas. Reg. § 1.59A-7(c)(2); (g)(2)(v)(Example 5).

77 *See* discussion in 2(b), above.

benefit is the amount of depreciation deductions allocated to DC with respect to such base erosion payments.[78]

In this situation, it seems appropriate to say that, even if the partnership does not provide for pro rata sharing of profits and losses, the base erosion tax benefits should be determined based on the transferee partner's distributive share of depreciation deductions from the relevant depreciable assets that correspond to the transferred partnership interest.

d) Base erosion tax benefits and allocations of depreciation deductions

Although base erosion tax benefits must be attributable to a base erosion payment, the Final Regulations provide that a partner's base erosion tax benefit may exceed the amount of the partner's base erosion payment to which it is attributable.[79] The Final Regulations offer the example of a partnership that makes a base erosion payment to acquire a depreciable asset from a foreign person and then specially allocates depreciation deductions from the asset to a related U.S. partner. The regulations provide that the base erosion payment is equal to the U.S. partner's proportionate share of the payment made to acquire the asset, but that all of the specially allocated depreciation deductions are base erosion tax benefits, even if the aggregate amount exceeds the base erosion payment.[80]

While we generally agree with the principle that base erosion tax benefits should be determined by reference to the depreciation deductions, this rule may produce results that are somewhat arbitrary in connection with partnership sharing arrangements involving non-pro rata allocations, such as Example 6, above. In this situation, DC has a 50% capital interest in PRS. However, PRS may allocate DC 0%, 40% or 100% (or some combination thereof) of the depreciation deductions representing base erosion tax benefits, depending on the overall profit and loss situation of PRS, which may be wholly unrelated to the base erosion payment. Moreover, a disproportionately large (or small) allocation of base erosion tax benefits to DC in one year maybe reversed in a subsequent year by an offsetting profit allocation.

---

78 Treas. Reg. § 1.59A-2(g)(2)(iii)(Example 3).

79 Treas. Reg. § 1.59A-7(d)(1).

80 Treas. Reg. § 1.59A-7(d)(1). Since the base erosion tax benefits are determined by the allocations, it is not clear to us whether Treasury intends that the base erosion payment have independent significance. If the amount of the base erosion payment has significance in these circumstances, it would be helpful if the regulations could clarify this point.

We also recommend that Treasury clarify that specially allocated depreciation deductions in excess of the base erosion payment are not treated as base erosion tax benefits to the extent the deductions are attributable to an unrelated partner's proportionate share of partnership property.[81]

Example 10: Contribution of Property to a Partnership

FP, a foreign person, and X each hold 50% interests in a partnership PRS, which owns depreciable property A with a basis and value of 120. DC, a domestic corporation related to FP but unrelated to X, contributes 120 of cash to PRS in exchange for a 50% interest in PRS. In Years 1 and 2, property A generates 60 of depreciation deductions. Under PRS's allocation arrangements, which have substantial economic effect, PRS allocates the 60 of depreciation deductions from property A to DC.

Under the regulations, DC is treated acquiring property A proportionately from FP and X, and DC is treated as making a base erosion payment of 30 to FP for 25% of the depreciable property.[82]

DC's base erosion tax benefits should not include depreciation deductions with respect to the portion of the property treated as having been acquired from X.[83] While DC is allocated the first 60 of depreciation deductions from property A, only 30 of the depreciation should be treated as a base erosion tax benefit, since before the contribution only 50% of the property was treated as owned by FP.

Similar considerations would arise if a domestic corporation receives non-pro rata allocations of deductions from a partnership that purchased depreciable property from another partnership that has both foreign partners related to such domestic corporation and unrelated partners.

e) Proposed regulations on curative allocations

The Final Regulations treat remedial allocations of depreciation deductions as base erosion tax benefits to the extent they arise from property acquired (or treated as acquired) with a base erosion payment and are allocated to the taxpayer that is deemed to

---

81 Treas. Reg. § 1.59A-7(g)(2)(v)(Example 5) provides that base erosion tax benefits do not arise to the extent that the deductions are attributable to an unrelated partner's proportionate share of partnership property. However, neither the Final Regulations nor the Proposed Regulations provide guidance where the relevant partner is specially allocated aggregate depreciation deductions in excess of the base erosion payment.

82 Treas. Reg. § 1.59A-7(c)(3)(iii).

83 Treas. Reg. § 1.59A-7(g)(2)(v)(Example 5).

have made the base erosion payment.[84] There is ambiguity as to the treatment of curative allocations. While the term *base erosion tax benefit* includes deductions attributable to a base erosion payment "including as a result of section 704(b) and (c)",[85] the examples in the Final Regulations expressly mention depreciation deductions that are allocated with respect to contributed property and remedial allocations, leaving some ambiguity as to whether a base erosion tax benefit arises as a result of a curative allocation of an item of deduction to the taxpayer since the curative allocation would not come from the depreciation of the specific property acquired with the base erosion payment. It would be helpful for Treasury to clarify that deductions are treated the same, whether made pursuant to the remedial method or the traditional method with curative allocations.

The Proposed Regulations would extend this principle and treat curative allocations of income items away from a partner as base erosion tax benefits if they are substitutes for allocations of deductions from a base erosion payment.[86] Thus, in effect, the Proposed Regulations would treat curative allocations of income away from a partner in the same manner as allocations of deductions to the partner if they have the same effect on the taxpayer's share of partnership net income. We support the proposed rule, as it treats partners with economically equivalent allocations similarly for purposes of the BEAT rules, regardless of their choice of Section 704(c) allocation method or the choice of which item (deduction or income) is allocated to the benefit the relevant taxpayer.

4. Small partner exception

The 2018 Proposed Regulations included an exception for qualifying small partners, which the Final Regulations retain. Under this exception, a partner is not required to take into account its distributive share of any base erosion tax benefits attributable to a base erosion payment *made by* a partnership if the partner owns less than 10% of the capital and profits of the partnership at all times during the relevant tax year, the partner is allocated less than 10% of each item of partnership income, gain, loss, deduction or credit and the partner's interest in the partnership has a fair market value of less than $25 million on the last day of the tax year.[87] Any interest in the partnership held by a related party, including through indirect or constructive ownership, is treated as owned by the partner.[88] The constructive ownership rules take into account downward

---

84 Treas. Reg. § 1.59A-7(d)(1).

85 *Id.*

86 Prop. Treas. Reg. § 1.59A-7(c)(5)(v), (g)(2)(x).

87 Treas. Reg. § 1.59A-7(d)(2). The small partner exception applies only to a partner that is not a partnership. Treas. Reg. § 1.59A-7(e)(5).

88 Treas. Reg. § 1.59A-7(d)(2)(ii).

attribution under 318(a)(3) from partners and shareholders for this purpose. It is not clear to us why downward attribution to a corporation or partnership is relevant to determining whether a taxpayer is a small partner, unless the attribution is from a person with some amount of control over that corporation or partnership. Since the constructive ownership rules already limit downward attribution to corporations to circumstances in which a shareholder owns 50% of the corporation, we recommend that Treasury provide for a similar minimum ownership threshold for purposes of attributing ownership to a partnership from one of its partners for purposes of the small partner exception. We also note that the 10% per item limitation may make the exception unavailable as a practical matter in certain cases involving contributions of property that are subject to section 704(c) (for example in the case of a reverse section 704(c) allocation to a partner that contributes cash to a partnership).

We believe the Final Regulations' significant expansion of the types of partnership transactions that are covered by the aggregate approach, including the broad definition of a transfer of a partnership interest, will mean that, as a practical matter, any partnership that has related U.S. and foreign partners will be required to conduct a detailed review of each of its transactions and allocations each year to determine base erosion payments and base erosion tax benefits with respect to the partners. This review may be further complicated by the rule for tiered partnerships, which says that the partnership aggregate rules apply successively to each partnership and its partners in the chain of ownership.[89]

In light of the Final Regulations' expanded aggregate approach rules and definition of transfers of partnership interests, and in light of the complexity of the review that we expect will be necessary under these rules, we believe it would be appropriate to expand the small partner exception to cover base erosion tax benefits attributable to all transactions with partnerships, including as a result of actual or deemed transfers of partnership property.[90]

---

89 Treas. Reg. § 1.59A-7(c)(5).

90 We believe that actual transfers of partnership interests between related parties are appropriately taken into account under the aggregate rule, even for small partners.