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Report No. 1397
July 16, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable William M. Paul
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Re: *Report No. 1397 on Base Erosion and Anti-Abuse Tax*

Dear Messrs. Kautter and Paul:

Among the many changes effectuated by P.L. 115-97 (the "**Act**"), one of the most novel is the Base Erosion and Anti-abuse Tax (the "**BEAT**"), enacted as Section 59A of the Internal Revenue Code of 1986. 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 carryovers.

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 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, or in the deliberations of the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting initiatives.

This Report considers the structure and context of the new BEAT and makes suggestions for the Department of the Treasury and the Internal Revenue Service 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. The Report discusses the issues under the BEAT that we have identified so far and that we consider most significant. Part III of the Report is a detailed analysis of certain features of the BEAT provisions and discussion of our recommendations. In general, we comment on the statute as written without proposing revisions to it.

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

Respectfully submitted,

Karen G. Sowell
Chair

Enclosure

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Report No. 1397

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON BASE EROSION AND ANTI-ABUSE TAX

July 16, 2018

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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

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[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

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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. Related Party

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]

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[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

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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. Base Erosion Payments – Payments to a CFC

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

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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.

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[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. Partnerships

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

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[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

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[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. Modified Taxable Income

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

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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

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[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).