KPMG

Analysis of final regulations and additional proposed regulations under section 59A (“BEAT”)

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Definition of terms

AMT = alternative minimum tax

BEMTA = base erosion minimum tax amount

BETB = base erosion tax benefits

BIE = business interest expense

CFC = controlled foreign corporation

COGS = cost of goods sold

E&P = earnings & profits

ECI = effectively connected income

FDAP = fixed, determinable, annual or periodic

FDII = foreign-derived intangible income

GILTI = global intangible low-taxed income

GSIB = global systemically important banking organization

MTI = modified taxable income

NOL= net operating loss

PFIC = passive foreign investment company

QDP= qualified derivative payment

R&E = research & experimental

SCM = services cost method

TLAC = total loss-absorbing capacity

The Internal Revenue Service ("IRS") and the Department of the Treasury, collectively ("Treasury") on December 2, 2019, released final regulations (T.D. 9885) (the "final regulations") and proposed regulations (REG-112607-19) (the "2019 proposed regulations") under section 59A (the "base erosion and anti-abuse tax" or "BEAT").

Read the text of the **final regulations** [PDF 614 KB] (78 pages) and the **proposed regulations** [PDF 366 KB] (13 pages).

This report provides KPMG's initial analysis and observations about these regulations.

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Background

The 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017, and often referred to as the “Tax Cuts and Jobs Act”) introduced an additional tax in section 59A (the “BEAT”).

The BEAT targets certain large corporations that make base erosion payments to certain related foreign persons resulting in “base erosion tax benefits” (“BETBs”) (i.e., deductions and other specified tax benefits). An “applicable taxpayer” is a corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) that has average annual gross receipts of at least $500 million for the three-tax-year period ending with the preceding tax year, and has a “base erosion percentage” (generally the ratio of BETBs over the aggregate deductions (with limited exceptions) allowable to the taxpayer during the tax year) in excess of 3%. The base erosion percentage threshold is dropped to 2% in the case of taxpayers that are members of affiliated groups containing a bank or registered securities dealer.

The BEAT also acts as a minimum tax, in that it applies to the extent that a taxpayer's "modified taxable income" ("MTI") multiplied by the applicable BEAT rate exceeds the taxpayer's regular tax liability (with adjustments). This amount is the "base erosion minimum tax amount" ("BEMTA"), and is the taxpayer's BEAT liability. The BEAT rate is 5% for tax years beginning in calendar year 2018, 10% for tax years beginning after calendar year 2018, and 12.5% for tax years beginning after December 31, 2025, with the rate one percentage point higher for any taxpayer that is a member of an affiliated group that includes a bank or registered securities dealer. For purposes of calculating a taxpayer's BEMTA, MTI generally is calculated like taxable income, but with no deduction allowed for (i) BETBs, or (ii) the base erosion percentage of any net operating loss ("NOL") under section 172. No tax credits are applied for purposes of determining the BEMTA. A taxpayer's regular tax liability, however, is reduced (but not below zero) by all credits under the statute, with the exception of research and certain other section 38 credits for tax years beginning before 2026.

On December 21, 2018, Treasury published proposed BEAT regulations (the "2018 proposed regulations"). The 2018 proposed regulations provided guidance regarding, among other issues, which taxpayers are subject to section 59A, what a base erosion payment is, and how to calculate the BEMTA and the resulting BEAT liability. The 2018 proposed regulations allowed taxpayers to rely on the 2018 proposed regulations for years beginning after December 31, 2017, provided the taxpayer and all related parties consistently apply the proposed regulations for all such tax years that end before the regulations are finalized. For a more detailed discussion of the 2018 proposed regulations, read ***TaxNewsFlash***.

Highlights of the final and proposed regulations

The following features of the final regulations and 2019 proposed regulations, which are discussed in greater detail below, appear particularly noteworthy:

- **No carve-out for global intangible low-tax income ("GILTI")/subpart F inclusions.** Despite comments requesting a broad exception from base erosion payments for payments made by a domestic corporation to a CFC or PFIC, the final regulations do not adopt such an exception. In response to comments requesting an exception for subpart F, GILTI, and PFIC inclusions, the preamble to the final regulations notes certain policy and practical reasons for declining to extend the exceptions to such income inclusions.

- **Relief for non-recognition transactions.** In response to various comments received, the final regulations generally exclude from the definition of base erosion payment any amounts transferred to, or exchanged with, a foreign related party in a transaction described in sections 332, 351, and 368. However, any such transactions involving "other property" are not excepted, with other property generally defined as under sections 351(b), 356(a)(1)(B), and 361(b), as applicable, including liabilities described in section 357(b) (as well as assumption of liabilities, to the extent of gain recognized under section 357(c)). The final regulations also clarify that section 301 distributions are not exchanges, and so are not base erosion payments. However, the final rules also provide that redemptions of stock as defined in section 317(b) (including redemptions described in section 302(a) and (d) or section 306(a)(2)) are exchanges that potentially give rise to base erosion payments, as are exchanges of stock in section 304 redemptions or section 331 liquidations.

- **Allowed vs. allowable deductions.** Comments suggested that use of the term "allowed" in defining base erosion tax benefits ("BETBs") in both the Code and 2018 proposed regulations should lead to a conclusion that no BETB results from an otherwise allowable deduction that a taxpayer fails to claim on its tax return. The final regulations do not explicitly address this point and simply continue to use the term "allowed" in defining BETBs. As discussed further below, however, the 2019 proposed regulations provide a mechanism by which "allowable" deductions can be irrevocably waived so as not to be considered as "allowed." The preamble indicates that the government believes that a mechanism that makes the waiver irrevocable is necessary to impose a consistent treatment that would prevent taxpayers from potentially using some or all of the foregone deductions in a later year. Importantly, the preamble to the 2019 proposed regulations permits taxpayers to rely on this aspect of the proposed regulations for any tax year to which the BEAT applies.

- **Determination of the aggregate group's gross receipts and base erosion percentage**. In response to comments, the final regulations provide that the determination of gross receipts and the base erosion percentage of a taxpayer's aggregate group is made on the basis of the taxpayer's tax year and the tax year of each member of its aggregate group that ends with or within the applicable taxpayer's tax year (the "with-or-within method"). The proposed regulations contain additional rules designed to implement the with-or-within method, summarized below. The final regulations also clarify that the BETBs and deductions of a member of an aggregate group with a fiscal year beginning before January 1, 2018, are not included in determining the base erosion percentage of the aggregate group.

- **Transactions between members of an aggregate group.** The final regulations clarify that a transaction between parties is disregarded for purposes of the BEAT, when determining the gross receipts and base erosion percentage of an aggregate group, if both parties were members of the aggregate group at the time of the transaction—without regard to whether the parties were members of the aggregate group on the last day of the taxpayer's tax year.

- **Losses with respect to the sale or transfer of property are not base erosion payments.** In response to comments, the final regulations exclude such losses from the definition of base erosion payment. The preamble clarifies that the term base erosion payment does not include the amount of "built-in-loss" because that built-in-loss is unrelated to the payment made to the foreign related party. Further, to the extent that a transfer of built-in-loss property results in a deductible payment to a foreign related party that is a base erosion payment, the final regulations clarify that the amount of the base erosion payment is limited to the fair market value of that property.

- **Interest expense allocable to a foreign corporation's effectively connected income ("ECI").** In response to comments, the final regulations replace the worldwide liability ratio of the proposed regulations with a worldwide interest expense ratio (average worldwide interest expense due to foreign related parties over total average worldwide interest expense) for purposes of determining what U.S. branch interest expense is treated as paid to a foreign related party. The final regulations provide that the same ratio will apply regardless whether a taxpayer applies the adjusted U.S. booked liabilities method described in Reg. section 1.882-5(b) through (d) or the separate currency pools method described in Reg. section 1.882-5(e). The final regulations do not, however, adopt a fixed ratio or safe harbor for the worldwide interest ratio.

- **Section 988 losses.** The 2018 proposed regulations excluded from the definition of base erosion payment exchange losses with respect to section 988 transactions. Exchange losses with respect to section 988 transactions were also excluded from the denominator of the base erosion percentage calculation regardless whether the transactions were with foreign related parties. In response to comments, the final regulations exclude from the denominator only section 988 losses that are excluded from the numerator, rather than all section 988 losses.

- **Expand total loss absorbing capacity ("TLAC") securities exception to foreign TLAC.** In accordance with comments, the final regulations expand the scope of the TLAC exception (subject to certain limitations) to include internal securities issued by global systemically important banking organizations pursuant to laws of a foreign country that are comparable to the rules established by the Federal Reserve Board, where those securities are properly treated as indebtedness for U.S. federal income tax purposes.

- **"Add-back" method for computing modified taxable income ("MTI") retained.** Despite comments, the final regulations retain the add-back method, as opposed to the recomputation or any other method, to determine MTI without regard to both the BETBs and the base erosion percentage of NOL deductions.

- **Exclusion for AMT credits.** In response to comments, the final regulations provide that AMT credits, like overpayment of taxes and for taxes withheld at source, do not reduce adjusted regular tax liability for purposes of computing BEMTA. While this treatment was relatively clear with respect to the refundable portion of such credits, the final regulations expand it to the nonrefundable portion of such credits as well.

- **Exception for groups with de minimis banking and securities dealer activities.** In response to comments, the final regulations expand the de minimis exception from the proposed regulations to provide that the additional 1% add-on to the BEAT rate will not apply to a taxpayer that is part of an affiliated group with de minimis banking and securities dealer activities.

- **No section 15 blending for FY 2018.** The final rules clarify that section 15 does not apply to require a blended BEAT rate for taxpayers with fiscal years beginning in calendar year 2018 and ending in 2019. Accordingly, the rate for any tax year beginning in calendar year 2018 is 5%.

- **Anti-abuse rules finalized largely unchanged.** The final regulations add new examples aimed at clarifying the "principal purpose" standard and treatment of ordinary course transactions, as well as specific anti-abuse rules applicable to the new exception for specified nonrecognition transactions.

- **Applicability dates.** The final regulations (other than the reporting requirements for qualified derivative payments ("QDPs") in Reg. sections 1.6038A-2(b)(7), 1.1502-2, and 1.1502-59A) apply to tax years ending on or after December 17, 2018. Taxpayers also are permitted to apply the final regulations in their entirety for tax years ending before December 17, 2018, but must do so consistently and cannot selectively choose which particular provisions to apply. Taxpayers also may rely on the 2018 proposed regulations in lieu of the final regulations for all tax years ending on or before December 6, 2019, provided the taxpayer applies the 2018 proposed regulations in their entirety (subject to an exception noted below).

BEAT additional proposed regulations (2019)

- **Election to waive allowable deductions.** The 2019 proposed regulations provide an election to waive deductions, and provide that all allowable deductions for which no election is made are treated as "allowed" deductions even if not claimed by the taxpayer. A taxpayer may make the election to waive deductions on its original filed federal income tax return, by an amended return, or during the course of an examination of the taxpayer's income tax return for the relevant tax year pursuant to procedures prescribed by the IRS Commissioner. Further, until the 2019 proposed regulations are finalized, a taxpayer choosing to rely on the proposed regulations may make this election by attaching a statement with the required information to its Form 8991. The election is made on an annual basis and a taxpayer is not bound by the prior year's election. Additionally, the election is not a method of accounting for purposes of section 446.

- **Aggregate group rules.** The 2019 proposed regulations provide rules for determining a taxpayer's aggregate group based on the "with-or-within" method adopted by the final regulations, including how the rule applies to short years and when members join or leave the group. For short years, the 2019 proposed regulations provide that a taxpayer must use a "reasonable approach" that "neither over-counts nor under-count the gross receipts, BETBs, and deductions of the aggregate group of the taxpayer." With respect to entry/exit of members, the proposed rules clarify that only items occurring while a member was in the group are counted for purposes of determining a taxpayer's gross receipts and base erosion percentage (i.e., items from before the member joined or after the member left are not counted). The 2019 proposed regulations also clarify that there is no double counting of a corporation's gross receipts, BETBs, or deductions, by application of the predecessor rule.

- **Application to partnerships**. The 2019 proposed regulations provide several new rules aimed at clarifying the application of the BEAT to partners and partnerships. Noting that curative allocations can provide a partner with the benefits of a deduction in the partnership setting, the proposed regulations provide that a partner is treated as having a BETB to the extent the partnership places a taxpayer in an "economically equivalent position by allocating less income to that partner in lieu of a deduction to that partner." There are also new anti-abuse rules aimed at derivatives on partnership interests and targeting allocations by a partnership to prevent or reduce a base erosion payment. Additionally, the proposed regulations request comments on the application of ECI to partners and partnerships and provide rules for filing partnership returns.

- **Applicability date.** The rules in Prop. Reg. sections 1.59A-7(c)(5)(v) (regarding partnership allocations in lieu of deductions), 1.59A-9(b)(5) (anti-abuse—partner derivative rule) and (6) (anti-abuse—allocation to eliminate or reduce base erosion payment) apply to tax years ending on or after December 2, 2019. The rules in Prop. Reg. sections 1.59A-2(c)(2)(ii) and (c)(4) through (6) (for determining applicable taxpayer status) and 1.59A-3(c)(5) and (6) (relating to the waiver of deductions) apply to tax years beginning on or after December 6, 2019. Taxpayers are expressly permitted to rely on the 2019 proposed regulations in their entirety for tax years beginning after December 31, 2017, and before the final regulations are applicable. If a taxpayer chooses to apply both the 2019 proposed regulations and the 2018 proposed regulations to a tax year ending on or before December 6, 2019, the taxpayer is not required to apply aggregate group rules in Prop. Reg. sections 1.59A-2(c)(2)(ii), (c)(4), (c)(5), and (c)(6) to that tax year.

Applicable taxpayer

The final regulations largely follow the applicable taxpayer rules contained in the 2018 proposed regulations, except for the rules that apply when the specific taxpayer is part of an aggregate group with other members that have different tax years, and the rules addressing when entities join or leave an aggregate group.

General rules

Section 59A applies to certain large taxpayer groups whose U.S. base erosion payments equal or exceed a specified percentage of their deductible payments ("applicable taxpayers"). As stated above, section 59A(e) defines an applicable taxpayer as a corporation (other than a regulated investment company ("RIC"), real estate investment trust ("REIT"), or S corporation) or, as discussed further below, a controlled group of corporations, that has both average annual gross receipts of at least $500 million for the three preceding tax years (the "gross receipts test"), and a base erosion percentage for the tax year in excess of the applicable threshold (the "base erosion percentage test").

Aggregation rules

For purposes of determining applicable taxpayer status, section 59A(e)(3) adopts a modified version of the section 1563(a) group rules, generally applying a more than 50% ownership threshold, to treat an "aggregate group" of corporations as one taxpayer. Once the aggregate group is determined, the final regulations require each taxpayer that is a member of the aggregate group to determine its gross receipts and base erosion percentage as of the end of its tax year.

KPMG observation

Notably, although RICs and REITs are excluded from the definition of an applicable taxpayer under section 59A(e), and therefore are not subject to the BEAT, the final regulations, like the 2018 proposed regulations, do not exclude RICs and REITs from membership in an aggregate group. The preamble to the final regulations explains that an aggregate group may include RICs and REITs because neither section 1563(a) nor section 1563(e) excludes the stock of, or held by, a RIC or REIT from the section 1563(a) definition of a controlled group of corporations.

Similarly, Treasury rejected a request that the final regulations exclude from the aggregate group foreign governments that are treated as foreign corporations under section 892.

As a general rule (and subject to the special method that applies when an aggregate group includes members with different tax years), for purposes of determining gross receipts and base erosion percentage, each member must take into account the gross receipts, BETBs and other deductions of all of the members of the aggregate group. For these purposes, the final regulations generally eliminate payments between members of the aggregate group, so that a deductible intragroup payment would generate neither additional gross receipts nor base erosion payments. The final regulations eliminate the rule from the 2018 proposed regulations that determined the aggregate group as of the end of the taxpayer's tax year. As discussed further below, the final regulations broadly take an aggregate approach to partnerships and test partners' distributive shares of partnership items (gross receipts, deductions, etc.) at the partner level.

The final regulations retain the rule provided in the 2018 proposed regulations that generally would exclude foreign corporations from the aggregate group, except with regard to transactions related to income that is, or is treated as, income effectively connected with the conduct of U.S. trade or business ("ECI"). If a foreign corporation is subject to tax in the United States on a net basis under the provisions of a tax treaty, the foreign corporation is excluded from the aggregate group except with respect to income taken into account in determining its net taxable income.

KPMG observation

As in the 2018 proposed regulations, the final regulations provide that all payments between members of an aggregate group *at the time of the transaction* shall be disregarded for purposes of the gross receipts and base erosion percentage tests. This rule is applied on a transaction-by-transaction basis, and the final regulations clarify that such transaction(s) will remain disregarded even if the parties are no longer members of the same aggregate group on the last day of the taxpayer's tax year.

KPMG observation

Because foreign corporations are treated as members of the aggregate group only to the extent transactions are treated as giving rise to ECI (or included in determining net income under a treaty), the same foreign corporation may be considered a member of an aggregate group with respect to one transaction but not another. For example, assume that a foreign corporation (Foreign Parent) that is not located in a treaty jurisdiction wholly owns U.S. Subsidiary, and also has a U.S. trade or business subject to U.S. federal income tax on its net income. U.S. Subsidiary makes two deductible payments to Foreign Parent—one that is included in Foreign Parent's ECI and one that is not. Foreign Parent would be considered part of the aggregate group with respect to the ECI-related payment and, therefore, the payment would be disregarded in determining applicable taxpayer status. However, Foreign Parent would not be part of the aggregate group with respect to the non-ECI payment, and that payment would be taken into account for purposes of the gross receipts and base erosion percentage tests.

KPMG observation

Foreign financial institutions frequently conduct their U.S. business both though a U.S. branch of the foreign bank and through a consolidated group of corporations that are generally required to be organized under a single U.S. entity. It is customary for frequent payments to be made between the U.S. branch and the members of the consolidated group, and there was a concern the ECI-related payments would be included in both the gross receipts and base erosion percentage tests. The final regulations retain the taxpayer-favorable aggregate approach for these institutions.

As discussed above, for aggregate groups that include members that are separate taxpayers (e.g., different U.S. consolidated groups) with different tax years, such members may have different base erosion percentages and gross receipts amounts under both the 2018 proposed regulations and the final regulations. Specifically, the 2018 proposed regulations would have required each separate taxpayer to apply the gross receipts and base erosion percentage tests for its tax year based on the aggregate group's data, taking into account the results of all other members of its aggregate group during that period that comprises the taxpayer's tax year, effectively putting all members of the aggregate group on the taxpayer's tax year for this limited purpose.

In response to comments that expressed concern regarding the potential administrative burdens of treating all members of a taxpayer's aggregate group as having the same tax year as the taxpayer, the final regulations depart from the method provided in the 2018 proposed regulations and instead adopt the "with-or-within" method to determine the gross receipts and the base erosion percentage of an aggregate group. Under the with-or-within method each taxpayer includes the results of other members of the aggregate group based on the other members' tax year that ends with or within the taxpayer's tax year.

Treasury eliminated special rules contained in the 2018 proposed regulations that addressed special circumstances and issued a new set of 2019 proposed regulations providing guidance for such special circumstances (discussed in greater detail below).

KPMG observation

The adoption of the "with-or-within" method in the final regulations is generally taxpayer favorable and should somewhat reduce the significant data collection and systems challenges that would have afflicted groups with numerous separate U.S. taxpayers under the 2018 proposed regulations.

Specific aggregate group rules regarding application of the with-or-within approach under the 2019 proposed regulations

As noted above, the final regulations do not include specific rules addressing the application of the "with-or-within" approach to special circumstances. Rules applying the aggregate group rules in those circumstances are included in the 2019 proposed regulations and may be relied upon for tax years beginning after December 31, 2017, and before final regulations are applicable, provided such taxpayer applies the 2019 proposed regulations in their entirety.

Short tax years

The 2019 proposed regulations include the short tax year annualization rule (the "annualization rule") that was contained in the 2018 proposed regulations, with modifications for taxpayers that are part of an aggregate group. The annualization rule requires taxpayers with a short tax year to annualize their gross receipts for purposes of the gross receipts test by multiplying their gross receipts for the short tax year by 365; such amount is then divided by the number of days in the short tax year. If a taxpayer with a short tax year is a member of an aggregate group, the taxpayer must use a "reasonable approach" to determine its gross receipts and base erosion percentage so as to not over-count or under-count gross receipts, base erosion benefits, and deductions, even when the tax year of members of the aggregate group do not end with or within the taxpayer's tax year. The 2019 proposed regulations provide no additional guidance regarding whether a particular method is a reasonable approach.

KPMG observation

The 2019 proposed rule for short tax years appears to provide significant flexibility, but whether any particular approach is reasonable will require a facts and circumstances analysis. Treasury requests comments on identifying the best approach for determining the gross receipts and base erosion percentage of an aggregate group for purposes of section 59A when a taxpayer or aggregate group member has a short tax year.

Predecessors

As in the 2018 proposed regulations, the 2019 proposed regulations provide that any reference to a taxpayer includes a reference to any predecessor of the taxpayer for purposes of the gross receipts determination. The term "predecessor" would include the distributor or transferor corporation in a section 381 asset reorganization transaction in which the taxpayer is the acquiring corporation. In response to comments that identified potential double-counting concerns with the predecessor rule contained in the 2018 proposed regulations, the 2019 proposed regulations clarify that the gross receipts of corporations that are members of both the taxpayer's aggregate group and the predecessor's aggregate group should not be double-counted. Similar to the approach under the newly proposed annualization rule, the new predecessor rule does not lay out a pathway to achieve the "no duplication result."

Members leaving and joining an aggregate group

The 2019 proposed regulations also provide additional guidance on the treatment of members that join or leave the aggregate group of a taxpayer. This proposed rule would provide that items of members that occur before any such member joins the taxpayer's aggregate group or after any such member leaves the taxpayer's aggregate group are not taken into account by the taxpayer for purposes of determining the gross receipts and the base erosion percentage of the taxpayer's aggregate group. To effectuate this outcome, a member would have a deemed tax year-end immediately before joining or leaving the taxpayer's aggregate group. Gross receipts of an aggregate group that are attributable to a leaving member are not reduced, however, as a result of the member leaving the group.

The proposed rule would generally apply a "closing of the books" method to determine which items of the joining or leaving member occur during the period when the corporation is a member of the taxpayer's aggregate group. In the case of items other than "extraordinary items" (as defined in Reg. section 1.1502-76(b)(2)(ii)(C)), however, those items would be allocated on a pro-rata basis without a closing of the books.

The 2019 proposed regulations include an example illustrating the application of the "member leaving the aggregate group" rule (Prop. Reg. section 1.59A-2(f), Example 2). In Example 2, Parent Corporation wholly owns Corporation 1 and Corporation 2. Each corporation is a domestic corporation and a calendar year taxpayer that does not file a consolidated return. The aggregate group of Corporation 1 includes Parent Corporation and Corporation 2. At noon on June 30, Year 1, Parent Corporation sells the stock of Corporation 2 to Corporation 3, an unrelated domestic corporation, solely in exchange for cash. Before the acquisition, Corporation 3 was not a member of an aggregate group.

The analysis states that in order to determine the gross receipts and base erosion percentage of the aggregate group of Corporation 1 for calendar Year 1, Corporation 2 is treated as having a tax year end immediately before noon on June 30, Year 1. Accordingly, Corporation 1's aggregate group takes into account only the gross receipts, BETBs, and deductions of Corporation 2 attributable to the period from January 1, Year 1, to immediately before noon on June 30, Year 1. The same results apply for purposes of determining the items taken into account by Parent Corporation's aggregate group in Year 1.

KPMG observation

The requirement to perform gross receipts and base erosion percentage calculations on the basis of a deemed tax year-end for members joining or leaving a group appears to reintroduce the administrative complexity that the "with or within" rule was intended to address.

KPMG observation

The effect of the 2019 proposed regulations is to reverse the 2018 proposed regulations' treatment of members that join or leave aggregate groups. The determination of a taxpayer's aggregate group as of the end of the taxpayer's tax year under the 2018 proposed regulations had the effect of importing into the new group all of the new member's BETBs and its full history of gross receipts, and of removing them in their entirety from the member's old aggregate group. The 2019 proposed regulations, in contrast, leave gross receipts and BETBs arising before the departure of a member with the member's old aggregate group, and assign to the new aggregate group only amounts arising after the member joins.

Aggregate group base erosion percentage transition rule

In response to comments, the final regulations modify the transition rule provided in the 2018 proposed regulations for groups with members that have fiscal years beginning before January 1, 2018, and ending in 2018. The 2018 proposed regulations would have provided that each taxpayer must determine the scope of pre-effective date payments by using its own tax year for all members of the taxpayer's aggregate group. Notably, the proposed rule meant that a calendar year group member would be required to take into account amounts paid or accrued by fiscal year group members during all of 2018, even if a portion of those amounts were pre-effective date payments with respect to those fiscal year members. Treasury agreed with comments that it is not appropriate for a taxpayer to include BETBs and deductions attributable to a tax year that begins before the effective date of section 59A when determining the aggregate group's base erosion percentage. Accordingly, the final regulations exclude the BETBs and deductions attributable to the tax year of a member of the aggregate group that begins before January 1, 2018, for purposes of determining the group's base erosion percentage.

Gross receipts test

The final rules adopt the rules contained in the 2018 proposed regulations for applying the gross receipts test, i.e., determining whether the average annual gross receipts of the aggregate group (with reference to that taxpayer's taxable period) for the prior three-taxable-year period are at least $500 million.

The 2018 proposed rules would define the term "gross receipts" for purposes of section 59A by reference to Reg. section 1.448-1T(f)(2)(iv). Despite receiving comments requesting that the final regulations deviate from the general definition of gross receipts under Reg. section 1.448-1T(f)(2)(iv) with respect to certain financial services transactions involving certain inventory and similar transactions, the final regulations do not adopt the approach suggested in such comments and continue to define the term "gross receipts" by cross-referencing Reg. section 1.448-1T(f)(2)(iv).

The gross receipts of a consolidated group are determined by aggregating the gross receipts of all of the members of the consolidated group (but eliminating intra-group payments). Consistent with the rule noted above, a foreign corporation's gross receipts include only gross receipts that are included in determining ECI or, under an applicable tax treaty, in net taxable income attributable to a U.S. permanent establishment. For any corporation that is subject to tax under subchapter L (or any corporation that would be subject to tax under subchapter L if that corporation were a domestic corporation), gross receipts are reduced by return premiums (within the meaning of sections 803(a)(1)(B) and 832(b)(4)(A)), but are not reduced by any reinsurance premiums paid or accrued.

For taxpayers in existence for less than the full three-taxable-year period, the final regulations require the taxpayer to determine its average gross receipts for the period it was in existence. Notably, the final regulations provide that this period will include the current tax year.

KPMG observation

The BEAT statute appeared to require a taxpayer to be in existence for at least one tax year before it could be an applicable taxpayer. The final regulations change this so that the gross receipts of a new company in its first tax year would be counted in determining applicable taxpayer status.

Base erosion percentage test

Base erosion percentage threshold

Under section 59A(e), a taxpayer generally satisfies the base erosion percentage test if the taxpayer has a base erosion percentage (calculated under the aggregation rules discussed above) of 3% or more.

As a general matter, an aggregate group that includes a member of an affiliated group (as defined in section 1504(a)(1)) that includes a domestic bank or a registered securities dealer is subject to a 2% threshold. The final regulations retain the rule provided under the 2018 proposed regulations that includes a de minimis exception that turns off the lower, 2% threshold for a tax year if the total gross receipts of the aggregate group that are attributable to the bank or the registered securities dealer represent less than 2% of the total gross receipts of the aggregate group. The de minimis rule applies to a consolidated group, if there is no aggregate group.

KPMG observation

This rule retains the relief afforded under the 2018 proposed regulations for groups that primarily conduct a non-financial services business but own a small bank within their affiliated group. For example, a number of large retailers own small banks that provide limited banking services to their customers (e.g., credit card services). Further, taxpayers otherwise subject to the 3% threshold may not be negatively impacted if they acquire a target group that includes a small bank or registered securities dealer.

Base erosion percentage calculation

Under section 59A(c)(4), a taxpayer's base erosion percentage for a tax year is calculated using the following fraction (with all referenced amounts arising during the tax year)—

(i) The aggregate amount of BETBs (the "numerator"), divided by
(ii) An amount (the "denominator") equal to:
- (A) The aggregate amount of the taxpayer's allowable deductions as well as certain BETBs arising from reductions to gross income (described below);
- (B) Reduced by
  - Deductions allowed under sections 172 (NOLs), 245A (participation exemption), or 250 (foreign derived intangible income ("FDII") and GILTI);

- Deductions for payments for services that qualify for the services cost method ("SCM") exception; and
- Deductions for payments that qualify for the qualified derivative payment ("QDP") exception.

As referenced above, certain reductions from gross income qualify as BETBs. Those BETBs—certain premiums or other consideration paid to a foreign related party for reinsurance, and reductions of gross income arising from payments to certain expatriated entities—are included in both the numerator and the denominator.

The final regulations retain several taxpayer-favorable rules provided in the 2018 proposed regulations for calculating the base erosion percentage. As in the 2018 proposed regulations, the final regulations clarify that the numerator does not include deductible payments to related foreign persons that qualify for one of the exceptions to the definition of a base erosion payment. In addition, the final regulations retain the rule that includes in the denominator an amount paid to a related foreign person that is not a member of the aggregate group if the payment qualifies for the ECI exception and the payment also qualifies for either the QDP exception, total loss absorbing capacity ("TLAC") exception, or services cost method ("SCM") exception (all discussed further below). As discussed in more detail below, however, while the 2018 proposed regulations excluded all exchange loss from a section 988 transaction from the denominator, the final regulations exclude from the denominator only exchange loss with respect to transactions with foreign related parties that are excluded from the numerator.

In addition, the final regulations generally retain the scaled inclusion rule under the 2018 proposed regulations for BETBs related to payments subject to U.S. withholding tax, but include a technical correction to the fraction used to determine the amount of a base erosion payment that is treated as a BETB after the application of an income tax treaty on the withholding tax rate. The final regulations provide that the amount of the BETB that is not included in the numerator if the payment was subject to withholding tax under sections 871 or 881 (as non-ECI FDAP), and on which withholding has occurred at a reduced rate under a treaty, is determined by reference to the fraction equal to the rate of tax imposed by the treaty over the rate of tax imposed without regard to the treaty. Full withholding (i.e., at the statutory rate) results in elimination of the full amount of the BETBs from the numerator. Partial withholding, for example, under an applicable income tax treaty, results in elimination of a proportionate amount of the BETBs from the numerator. For example, a 10% withholding tax—imposition of 1/3 of the statutory withholding tax rate—eliminates 1/3 of the BETB from the numerator.

Finally, in response to comments, the final regulations include a new rule that is taxpayer-favorable for certain U.S. inbound foreign companies that are subject to the branch-level interest tax, which is not technically subject to U.S. withholding tax. This new rule reduces any BETB attributable to interest in excess of interest on U.S.-connected liabilities by the amount of excess interest on which tax is imposed on the foreign corporation under section 884(f), provided the tax is properly reported and paid by the foreign corporation.

Mark-to-market rules

The 2018 proposed regulations provided specific rules for determining the amount of deductions that are included in the denominator that arise from mark-to-market transactions (e.g., contracts that are marked-to-market under sections 475 and 1256). Specifically, for any position with respect to which the taxpayer (or a member of the aggregate group) uses mark-to-market tax accounting for U.S. federal income tax purposes, the taxpayer must determine its gain or loss with respect to that position by combining all items of income, gain, loss, or deduction arising with respect to the position during the tax year (the "BEAT netting rule"). If the combination of these items results in a net loss, the taxpayer would include the net loss in the denominator, unless the QDP exception applies.

The final regulations retain this rule. The preamble clarifies that Treasury intends for the rule to apply to any position with respect to which the taxpayer or a member of its aggregate group applies a mark-to-market method, including physical securities (e.g., stock or debt), repurchase agreements, and securities lending agreements.

Partnerships and applicable taxpayer status

Partnerships are not themselves included as applicable taxpayers or members of an aggregate group. Instead, consistent with the 2018 proposed regulations, the final regulations generally take an aggregate approach to partnerships and apply section 59A at the partner level for purposes of determining whether a corporate partner is an applicable taxpayer.

For purposes of applying the gross receipts test, a U.S. corporate partner in a partnership takes into account its distributive share of the partnership's gross receipts (if necessary, through tiers of partnerships). A foreign corporate partner does the same, but takes into account only its distributive share of items related to ECI (or, in the treaty context, to net taxable income).

For purposes of applying the base erosion percentage test, a partner in a partnership generally is treated as having paid or accrued its allocable share of amounts paid or accrued by the partnership. The determination of whether a payment by a partnership is made to a related foreign person is made by reference to its partners. Similarly, for purposes of characterizing a payment made to a partnership, the payor generally is treated as having paid an amount to each partner, based on that partner's distributive share of income with respect to that amount.

The final regulations adopt the de minimis exception in the 2018 proposed regulations for purposes of determining the amount of a partner's BETBs; the de minimis exception does not apply for purposes of determining the partner's gross receipts. Under the exception, a partner is not required to take into account its distributive share of any of the partnership's potential BETBs for the tax year if all three of the following requirements are satisfied: (i) the partner's interest in the partnership represents less than 10% of the capital and profits of the partnership at all times during the tax year; (ii) the partner is allocated less than 10% of each partnership item of income, gain, loss, deduction, and credit for the tax year; and (iii) the partner's interest in the partnership has a fair market value of less than $25 million on the last day of the partner's tax year, determined using a reasonable method.

The final regulations clarify that a partner's distributive share of a partnership item of income or deduction is determined for these purposes under sections 704(b) and (c), taking into account amounts determined under other provisions of the Code, including sections 707(a) and (c), 732(b) and (d), 734(b) and (d), 737, 743(b) and (d), and 751(b). These amounts are calculated separately for each payment or accrual on a property-by-property basis, including for purposes of section 704(c), and are not netted. The final regulations also provide several new rules for purposes of determining base erosion payments and BETBs in connection with certain partnership transactions. Those rules are discussed in detail below.

Base erosion payments

In general

Section 59A(d) defines a base erosion payment as any amount paid or accrued by a taxpayer to a foreign related party that falls into one of four categories: (i) payments or accruals for which a deduction is allowable; (ii) payments or accruals in connection with the acquisition from the foreign related party of depreciable or amortizable property; (iii) premiums or other consideration paid or accrued for reinsurance, and (iv) certain payments or accruals with respect to a surrogate foreign corporation or its expanded affiliated group that result in a reduction of the taxpayer's gross receipts. Specifically excluded from this definition, however, are qualified derivative payments ("QDPs"), as well as certain payments that would otherwise qualify for the services cost method ("SCM") under Reg. section 1.482-9, with certain modifications.

The 2018 proposed regulations provided operating rules for determining whether an amount is a base erosion payment. They also provided guidance on the scope of statutory exceptions from base erosion payments and added new exceptions. The final regulations largely continue the approach of the 2018 proposed regulations, with some notable exceptions discussed below.

Operating rules

The final regulations clarify that the determination of whether a payment or accrual is a base erosion payment, under one of the four enumerated categories, is made under general U.S. federal income tax law. Previously, under the 2018 proposed regulations, this intention was only noted in the preamble.

The 2018 proposed regulations provided that, in general, amounts of income and expense are determined on a gross rather than a net basis for purposes of determining base erosion payments, apart from with respect to the mark-to-market rules discussed above. The final regulations retain this approach, despite comments requesting broader netting of income and expense for base erosion payments.

Treatment of nonrecognition transactions and loss transactions

The final regulations moderate the 2018 proposed regulations' expansive approach to what is a payment or accrual for purposes of a base erosion payment. Under the 2018 proposed regulations, an amount paid or accrued included any form of consideration, including cash, property, stock, or the assumption of a liability. The preamble to the 2018 proposed regulations noted that nonrecognition transactions, such as section 351 exchanges, section 332 liquidations, and section 368 reorganizations, also would be base erosion payments under the proposed definition because they were not specifically excepted.

In response to numerous comments, the final regulations provide an exception from base erosion payment treatment for amounts transferred to, or exchanged with, a foreign related party in a transaction to which sections 332, 351, 355, or 368 apply (specified nonrecognition transactions), subject to an anti-abuse rule discussed below. However, any "other property" (boot) transferred in such a transaction is not excepted, with other property generally defined as under sections 351(b), 356(a)(1)(B), and 361(b), as applicable, including liabilities described in section 357(b) (as well liabilities assumed, but only to the extent of gain recognized under section 357(c)). The final regulations also clarify that section 301 distributions are not exchanges, and so not base erosion payments. However, the final rules also provide that redemptions of stock as defined in section 317(b) (including redemptions described in section 302(a) and (d) or section 306(a)(2)) are exchanges that potentially give rise to base erosion payments, as are exchanges of stock in section 304 redemptions and section 331 liquidations.

The preamble to the 2018 proposed regulations further clarified that Treasury considered a base erosion payment to include a transfer of property with basis in excess of value to a foreign related party, resulting in a recognized loss. In response to comments, the final regulations exclude such losses from the definition of base erosion payment. The preamble to the final regulations clarifies that a base erosion payment does not include the amount of such a loss because that loss is unrelated to the payment made to the foreign related party. Further, to the extent that a transfer of loss property results in a deductible payment to a foreign related party that is a base erosion payment, the final regulations clarify that the amount of the base erosion payment is limited to the fair market value of that property.

Exceptions

The final regulations elaborate and expand on some of the exceptions introduced in the 2018 proposed regulations, but other than the specified nonrecognition transactions described above, do not create new exceptions from the definition of base erosion payment.

Reductions in gross receipts, including cost of goods sold (“COGS”)

In line with the conference report, the final regulations explicitly state that payments resulting in a reduction to determine gross income, including COGS, are not treated as base erosion payments.

Comments requested numerous expansions of the carve-out for payments resulting in a reduction to determine gross income, which the final regulations decline to adopt:

- With respect to captive finance subsidiaries, comments requested treatment of depreciation deductions attributable to property purchased from a foreign related party and leased to an unrelated third party end user as COGS for BEAT.

- For capitalization and amortization of research and experimental (“R&E") expenditures, comments suggested limiting the base erosion payment to the amount of amortization.

- In “pass through” transactions, comments requested excepting situations where a domestic corporation makes a deductible payment to a foreign related party, and that foreign related party in turn makes corresponding payments to unrelated third parties—under the theory that in industries where such transactions are prevalent (e.g., global services contracts and manufacturing) such costs are like COGS.

- Comments also requested an exception from base erosion payments for revenue sharing payments or arrangements, including allocations with respect to global dealing operations, under the reasoning that a payment is not a base erosion payment in a situation when there is a profit split or the domestic corporation records revenue from transactions with third party customers, and in turn the domestic corporation makes payments to a foreign related party.

KPMG observation

Consistent with generally applicable U.S. tax principles, the preamble to the final rules notes specifically that the use of a particular transfer pricing method, including a profit split, will not change the contractual relationship between parties, and that characterization will instead depend on the underlying facts and relationships between those parties. The preamble notes in particular that in the context of global dealing operations, there may be circumstances in which a particular global dealing operation can be viewed as co-ownership or a similar arrangement under general tax principles, such that no deductible payments are made between the participants. Such a characterization would depend on analysis of the underlying facts in light of generally applicable U.S. tax principles.

Services cost method (“SCM”)

The 2018 proposed regulations clarified that there is no base erosion payment for amounts that are eligible for the SCM exception to the extent of the total services cost of those services (i.e., not including any markup). Accordingly, under the 2018 proposed rules, the excess amount remained a base erosion payment. The 2018 proposed regulations also clarified the requirements for qualifying under the SCM exception under the BEAT, providing that a taxpayer must meet the requirements of Reg. section 1.482–9(b), with the exception of the business judgment rule in Reg. section 1.482-9(b)(5). Additionally, the 2018 proposed regulations modified the books and records requirement in Reg. section 1.482–9(b)(6).

The final regulations continue this approach, and in response to comments, provide additional detail on the documentation requirements for satisfying the books and records requirement. The final regulations decline, however, to adopt comments suggesting the exception should be expanded to include all services or some subset of services (such as R&E services).

Qualified derivative payments ("QDPs")

The 2018 Proposed Regulations provided detailed guidance on the scope of the exception for QDPs (the "QDP exception"), including guidance on the associated reporting requirements. For this purposes, the proposed regulations provided a definition of "derivative" for purposes of the QDP exception that did not include sale-repurchase agreements or securities lending transactions.

The final regulations, in response to comments, explicitly provide that the definition of derivative for purposes of the QDP exception excludes (1) a sale-repurchase transaction or substantially similar transaction that is treated as a secured loan for U.S. tax purposes, and (2) the cash leg of a securities lending transaction. However, the final regulations no longer expressly exclude securities lending transactions from the definition of a derivative. The preamble notes that the result of this change is that payments (such as a borrow fee or substitute payment) made with respect to the securities leg of a securities lending transaction may qualify as a QDP. However, the securities loan would still need to satisfy the other requirements to apply the QDP exception (e.g., the securities loan is subject to mark-to-market tax accounting).

The final regulations also include a new anti-abuse rule intended to address securities lending transactions that have a significant financing component. This anti-abuse rule excludes from derivative treatment securities lending transactions or similar arrangements that are part of an arrangement entered into with a principal purposes of avoiding treatment as a base erosion payment and that provide the taxpayer with the economic equivalent of a substantially unsecured cash borrowing. The rule further notes that this determination will take into account amounts that may effectively serve as collateral due to compliance with U.S. regulatory requirements.

QDP reporting requirements

The QDP exception by its terms applies only when a taxpayer satisfies certain reporting requirements. The 2018 proposed regulations clarified that if a taxpayer satisfied the reporting requirements for some, but not all, of its derivative payments, those payments that met the reporting requirements would continue to qualify for the QDP exception. The 2018 proposed regulations provided detailed reporting requirements (including reporting the aggregate amount of QDP by type and counterparty). The detailed reporting requirements would take effect for tax years beginning one year after the date final regulations were published in the Federal Register. Prior to that date, the 2018 proposed regulations provided that the reporting requirement would be treated as satisfied to the extent the taxpayer reported the aggregate amount of QDPs on Form 8991.

The final regulations clarify that the QDP reporting requirements apply to taxpayers regardless whether the taxpayer is a reporting corporation under 6038A. They also eliminate the requirement to report the aggregate amount of QDPs by type and counterparty, and instead require only reporting of the total aggregate amount of QDPs for the year, together with a representation that all payments to which the QDP exception is applied satisfy the QDP reporting requirements. The final regulations provide that to calculate the amount of a QDP, taxpayers will apply the BEAT netting rule for mark-to-market transactions, described above. The final regulations also include a transition period. During the transition period, the QDP reporting requirement is satisfied if a taxpayer reports the aggregate amount of QDPs in good faith. The transition period stops applying in tax years beginning 18 months after the date the final regulations are published in the federal register.

KPMG observation

Eliminating the requirement to separately state QDPs by type and counterparty is a significant and welcome simplification. The 18-month transition period is also welcome relief as taxpayers continue to encounter challenges when attempting to satisfy the QDP reporting requirement.

ECI exception

The 2018 proposed regulations would have added an exception to base erosion payment for amounts paid or accrued to a foreign related party that are subject to tax as income effectively connected with the conduct of a trade or business in the United States (the "ECI exception"), which is unchanged in the final regulations.

Despite several comments requesting an extension of the ECI exception to other amounts subject to U.S. tax through U.S. shareholders (i.e., GILTI, subpart F, and PFIC inclusions), the final regulations decline to extend the exception to such income inclusions—noting certain practical and policy reasons in the preamble to the final regulations.

Section 988 losses

The 2018 proposed regulations excluded from the definition of base erosion payment exchange losses with respect to section 988 transactions. Exchange losses with respect to section 988 transactions were also excluded from the denominator of the base erosion percentage calculation regardless of whether the transactions were with foreign related parties. In response to comments, the final regulations exclude from the denominator only section 988 losses that are excluded from the numerator, rather than all section 988 losses. The preamble notes that this treatment is consistent with the treatment of the exceptions for QDPs, amounts eligible for the SCM exception, and amounts paid or accrued to foreign related parties with respect to TLAC securities.

Exception for interest on "TLAC" securities issued by global systemically important banking organizations ("GSIBs")

The 2018 Proposed Regulations provided an exception from base erosion payment status for amounts paid to a foreign related party with respect to total loss-absorbing capacity (TLAC) securities required by the Board of Governors of the Federal Reserve Board. The amount of the exclusion was limited to the amount of TLAC securities required by the Federal Reserve. Notably, the exclusion did not extend to TLAC requirements imposed by foreign regulators, with the result that U.S. branches of foreign financial institutions were not entitled to a similar exception.

In response to comments, the final regulations add an exception for foreign TLAC of GSIBs that is treated as indebtedness for U.S. tax purposes. This exception is generally limited to the lesser of (1) the hypothetical Federal Reserve Board limitation that would apply if the U.S. branch were a domestic subsidiary, and (2) the minimum amount of TLAC debt required under the bank regulatory requirements of the relevant foreign country that are comparable to U.S. requirements. When the foreign country's TLAC rules do not specify a minimum amount, the limitation will be determined solely with respect to the hypothetical Federal Reserve Board limitation. For both TLAC securities and foreign TLAC securities, the final regulations increase the permitted exclusion to 115% of the amount of required TLAC, in order to permit maintenance of a buffer amount.

KPMG observation

The addition of the exclusion for foreign TLAC addresses a significant disparity between U.S. and foreign GSIBs created by the proposed regulations. It should be noted that the interaction of the foreign TLAC exception and the treaty-based interest expense allocation rules remains unclear. Foreign GSIBs may also encounter administrative complexities when computing the hypothetical Federal Reserve Board limitation.

Given the volatility in the amount of required TLAC, financial institutions will frequently issue TLAC in excess of the required amount. For such financial institutions, the 115% buffer is a welcome change in the final regulations.

Interest expense allocable to a foreign corporation's effectively connected income

The 2018 proposed regulations provided rules for foreign taxpayers with a U.S. trade or business or a permanent establishment to determine the amount of base erosion payments allocable against their ECI or business profits. Those rules varied depending on whether a foreign taxpayer calculated its taxable income by applying U.S. expense allocation rules or by relying on a treaty that applied a different method of allocating expenses (including special rules where a treaty method recognized internal dealings as part of an allocation of profits based on assets used, risks assumed, and functions performed).

With respect to interest expenses, the 2018 proposed regulations also distinguished between taxpayers applying the adjusted U.S.-booked liabilities (AUSBL) method under Reg. sections 1.882-5(b) through (d) or the separate currency pools (SCP) method under Reg. section 1.882-5(e).

The final regulations generally preserve the proposed regulations' treatment of expenses other than interest expense. With respect to interest expense, the final regulations treat as a base erosion payment the sum of (1) direct allocations under Reg. section 1.882-5(a)(1)(ii)(A) or (B) paid or accrued to a foreign related party; (2) interest expense on U.S. booked liabilities under Reg. section 1.882-5(d)(2) paid or accrued to a foreign related party; and (3) interest expense on U.S. connected liabilities (determined under the AUSBL or SCP method) in excess of interest expense on U.S. booked liabilities, multiplied by a "worldwide interest expense ratio," the numerator of which is the foreign corporation's average worldwide interest expense due to a foreign related party, and the denominator of which is the foreign corporation's average total worldwide interest expense, determined by translating interest expense into the foreign corporation's functional currency. With respect to item (2), the determination of interest expense on U.S.-booked liabilities is required regardless whether the foreign corporation applies the AUSBL method or the SCP method for purposes of determining its interest expense. Foreign corporations can elect to calculate the worldwide interest expense ratio on the basis of the (non-consolidated) financial statement of the foreign corporation rather than U.S. tax principles.

For purposes of this worldwide interest expense ratio, the final regulations provide a coordination rule with the exclusion from BETB status for payments subject to U.S. withholding tax, discussed below. Under this coordination rule, any interest (including branch interest under Reg. section 1.884-4(b)(1)) on which tax under section 871 or section 881 is imposed and has been deducted and withheld under section 1441 or section 1442, but which is not attributable to direct allocations or interest expense on

U.S. booked liabilities, is treated as not paid to a foreign related party for purposes of determining the worldwide interest expense ratio.

Under the final regulations, if a foreign corporation has U.S booked liabilities in excess of U.S.-connected liabilities (determined under the AUSBL or SCP method), the foreign corporation applies the scaling ratio to all interest expense on U.S.-booked liabilities for purposes of determining the amount of allocable interest expense on U.S.-booked liabilities. This rule applies regardless whether the foreign corporation applies the AUSBL or SCP method.

KPMG observation

The 2018 proposed regulations reached potentially significantly different results depending on whether a taxpayer applied the AUSBL method or the SCP method. The approach of the final regulations is intended to correct that disparity.

Allocation of interest and other expenses under tax treaties

With respect to foreign corporations applying a tax treaty, the 2018 proposed regulations provided that a foreign corporation calculating the business profits attributable to a U.S. permanent establishment under a tax treaty rather than under U.S. expense allocation rules must determine whether each allowable deduction attributed to the permanent establishment is a base erosion payment. In the case of a foreign corporation determining its attributable business profits based on the assets used, risks assumed, and functions performed by the permanent establishment, the 2018 proposed regulations generally treated the full amount of deductible "internal dealings" between the permanent establishment and the home office or another branch as base erosion payments.

In contrast, under the final regulations, if a foreign corporation determines its taxable income pursuant to an income tax treaty (and interest expense is not allocated under Reg. section 1.882-5), the foreign corporation must determine the portion of its interest expense that will be treated as a base erosion payment by performing a hypothetical Reg. section 1.882-5 calculation using the method described above. Any amount of interest expense allowed to the permanent establishment as a deduction in excess of that hypothetical Reg. section 1.882-5 interest expense is treated as a base erosion payment in its entirety (to the extent that the payment or accrual otherwise meets the definition of a base erosion payment).

KPMG observation

The elimination of the application of the 2018 proposed regulations' internal dealings rules to interest is likely to be a welcome change for foreign corporations applying treaties requiring the use of the "authorized OECD approach" for profit attribution. The revised rules now treat as a base erosion payment any amount in excess of the amount of interest expense that would be permitted under U.S. law, which is difficult to reconcile with U.S. tax treaty commitments.

The final regulations also continue to maintain the 2018 proposed regulations' internal dealings rules for deductions other than interest. Thus, for payments other than interest, an internal dealing is a base erosion payment to the extent that the payment or accrual otherwise meets the definition of a base erosion payment.

Base erosion tax benefits ("BETBs")

Section 59A(c)(2)(A) lists four categories of BETBs, which generally are defined as deductions (or reductions to income) attributable to the four corresponding categories of base erosion payments noted above. The amount of a taxpayer's BETBs is used to determine both its base erosion percentage (discussed above) and MTI (discussed below). The 2018 proposed regulations provided clarifications for taxpayers computing their BETBs, which the final regulations expand and modify.

Consistent with the ECI exception and the statute, the 2018 proposed regulations would have reduced the amount of the BETBs associated with deductible payments made to a foreign related party to zero when full U.S. withholding tax is imposed on such payment. If the U.S. withholding tax is reduced under an applicable treaty, however, the amount of the BETB is similarly reduced (but not to zero) to the extent of the withholding taxes paid. The final regulations follow this same approach.

Additionally, the 2018 proposed regulations clarified the treatment of interest payments when section 163(j) applies. For purposes of computing a taxpayer's BETBs, the statute prescribes a taxpayer unfavorable stacking rule that treats the interest that is limited under section 163(j) as attributable first to any interest paid to unrelated parties, with the result that an increased portion of the interest that is allowed is treated as paid to related parties and potentially subject to the BEAT. Notably, there was an ambiguity left by the statute regarding how the allowed interest should be allocated between foreign related parties and domestic related parties. The 2018 proposed regulations clarified this ambiguity by providing for an allocation between foreign related parties and domestic related parties in proportion to the interest actually paid to each. The 2018 proposed rules also provided guidance on the treatment of the excess interest carried over into future years, treating the amount of a disallowed business interest expense ("BIE") carryforward first as BIE paid to unrelated parties and then as BIE paid to related parties, proportionately between foreign and domestic related-party BIE. Further, with respect to BIE paid or accrued to a foreign related party to which the ECI exception applies, the 2018 proposed regulations classified such interest expense as domestic related BIE.

The final regulations largely follow the 2018 proposed regulations in the treatment of interest expense, except that, in response to comments, the final regulations confirm that BIE subject to the TLAC exception or excluded from BETBs under the withholding tax exception retains its classification as a payment to a foreign related party. The final regulations note, however, that the foreign related BIE category consists of interest that is eligible for these exceptions and interest that is not eligible for these exceptions, on a pro-rata basis.

Election to waive deductions

The 2019 proposed regulations provide a mechanism for taxpayers to waive deductions for purposes of BETBs. Under the 2019 proposed rules, a taxpayer may forgo a deduction and that forgone deduction will not be treated as a BETB, provided the taxpayer waives the deduction for all U.S. federal income tax purposes and follows the specified procedures. If a deduction is waived under the 2019 proposed rules, the taxpayer generally will not be able to claim the deduction for any purpose of the Code or regulations. The waiver is quite broad, and permits the waiver of deductions in whole or in part. Thus, a portion of a deduction associated with a particular cost or expense could be waived with the rest of the cost or expense retaining its character and remaining available as a deduction.

KPMG observation

Although BEAT generally does not apply at the state and local level, taxpayers should be aware that waiving deductions under this election may have the effect of increasing state and local taxes that reference federal taxable income.

Under the 2019 proposed regulations, all deductions that could be properly claimed by a taxpayer for the tax year, determined after giving effect to the taxpayer's permissible method of accounting and elections, are treated as allowed deductions for the BEAT, unless the taxpayer elects to waive certain deductions. This means if a taxpayer does not make an election to waive a deduction that could be properly claimed by a taxpayer for the tax year, and the deduction otherwise would be a BETB, the deduction is treated as a BETB and taken into account in the taxpayer's base erosion percentage and MTI even if not actually claimed by the taxpayer in that year.

The 2019 proposed regulations also include certain reporting rules in connection with the waiver of deductions, and provide guidance on the time and manner for electing to waive deductions. Under the 2019 proposed rules, a taxpayer may elect to waive deductions on its original filed federal income tax return, by an amended return, or during the course of an examination of the taxpayer's income tax return for the relevant tax year pursuant to procedures prescribed by the Commissioner. An election must also be reported on the appropriate forms, including Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*. Until the 2019 proposed regulations are final, a taxpayer may rely on the proposed regulations and elect to waive deductions by attaching a statement to its Form 8991 with the required information.

An election is made separately for each year, and a taxpayer does not need the consent of the Commissioner to not make the election for a subsequent year. Additionally, an election is not a method of accounting under section 446, and is disregarded in determining: (1) a taxpayer's overall method of accounting or its method of accounting for any item; (2) whether a change in the taxpayer's overall plan of accounting or its treatment of a material item is a change in method of accounting under section 446(e) and Reg. section 1.446-1(e); and (3) the amount allowable for depreciation or amortization under sections 167(c) and 1016(a)(2) or (3), and any other adjustment to basis under section 1016(a). An election is also disregarded for section 482, in determining a taxpayer's earnings and profits ("E&P"), and any other item as necessary to prevent a taxpayer from receiving the benefit of a waived deduction. Further, to ensure that a taxpayer is not able to reduce the amount of its BETBs with a waiver of deductions in a prior year and then recover the waived deductions in a subsequent year by making an accounting method change, the 2019 proposed regulations provide that if a change in method of accounting is made with respect to an item that had been waived, the previously waived portion of the item is not taken into account in determining the amount of adjustment under section 481(a).

KPMG observation

While a taxpayer may choose to file an amended return in order to waive additional deductions, under the 2019 proposed regulations a taxpayer is not permitted to reclaim deductions previously waived.

Sequentially, under the 2019 proposed regulations, an election to waive deductions generally is treated as occurring before the allocation and apportionment of deductions under Reg. sections 1.861-8 through -14T and 1.861-17. In the case of a deduction for interest expense that is directly allocable to income produced by a particular asset, however, the asset value is still reduced as if the deduction had not been waived. The election to waive deductions is disregarded in applying exclusive apportionment, under Reg. section 1.861-17(b), to determine the geographic source of R&E activities.

MTI

The final rules adopt verbatim the MTI rules contained in the 2018 proposed regulations. Treasury rejected several comments that requested changes to the MTI rules described in the 2018 proposed regulations, which are discussed at length in the preamble to the final regulations.

General rules

The BEAT imposes an additional tax on an applicable taxpayer equal to the BEMTA. This tax is computed on a taxpayer-by-taxpayer basis (with domestic corporations that join in filing a U.S. consolidated return treated as a single taxpayer), rather than on an aggregate group basis.

An applicable taxpayer's BEMTA is the excess of the applicable percentage of its MTI over its regular tax liability, with certain adjustments. The statute defines MTI as taxable income computed for the tax year under Chapter 1 "determined without regard to" any (i) BETBs and (ii) the base erosion percentage of any NOL deduction allowed under section 172 for the tax year.

Unchanged from the 2018 proposed regulations, the final rule interprets the statutory phrase "without regard to" as simply requiring the identified amounts to be added back to taxable income, rather than requiring a full redetermination of taxable income without regard to the disallowed deductions. In rejecting requests to adopt a redetermination approach, Treasury asserted that the add-back approach is more consistent with the statutory framework of section 59A.

KPMG observation

Both an add-back approach and various iterations of a recomputation approach seemed to be reasonable interpretations of the statutory language. Notwithstanding Treasury's assertions that the add-back approach is more consistent with the section 59A statutory framework, the recomputation approach still appears to be a more literal construction of the statutory language ("determined without regard to").

As asserted in comments to the 2018 proposed regulations received by Treasury, the adoption of the add-back approach provides the virtue of simplicity but may result in more BEAT liability in certain situations. In particular, taxpayers with significant attributes that are limited by their taxable income, such as NOLs and interest expense deductions, will be adversely affected by the adoption of the "add-back" approach.

Treatment of NOLs in reducing taxable income

Unchanged from the 2018 proposed regulations, the final regulations provide that an excess amount of NOL deduction cannot reduce taxable income below zero for determining the starting point for computing MTI. That is, a deduction for a pre-2018 NOL (which is not subject to the new limitation of 80% of taxable income) would be taken into account for purposes of the MTI starting point only to the extent of the amount of taxable income prior to the NOL deduction, with the result that an NOL carryover cannot cause MTI to become negative.

KPMG observation

Despite receiving comments asserting that this rule is inconsistent with the statutory language in sections 59A and pre-TCJA 172(a), Treasury rejected such arguments and asserted that the failure of section 172(a) to limit the amount of NOLs available to reduce regular taxable income was because there was no consequence to claiming a NOL deduction greater than 100% of current year taxable income prior to the enactment of the BEAT. Treasury asserted its grant of regulatory authority under section 59A(i) to limit the NOL deduction to taxable income in computing MTI on the basis that it is necessary and appropriate to prevent NOLs from being used multiple times to reduce MTI.

Retention of the vintage year approach to NOLs

Unchanged from the 2018 proposed regulations, the final regulations provide that the base erosion percentage of an NOL is the base erosion percentage of the applicable taxpayer in the year in which the loss arose (defined in the preamble as the "*vintage year*"), rather than the base erosion percentage of the year in which the NOL is applied to reduce taxable income. If the applicable taxpayer is a part of an aggregate group, the base erosion percentage is the aggregate group's base erosion percentage for the year in which the NOL arose, even though the applicable taxpayer's NOL is not determined by reference to the aggregate group. Consistent with the vintage year approach, the base erosion percentage for NOLs that arose in tax years beginning before January 1, 2018 is zero, because the BEAT does not apply to tax years beginning before January 1, 2018. The preamble explains that the "vintage year" approach is the preferred method because it provides greater certainty as to the portion of an NOL that will have to be added back, since the percentage used to determine the NOL add-back would be fixed in the year the NOL arose.

KPMG observation

While Treasury received at least one comment requesting re-consideration of the use of the taxpayer's aggregate group's base erosion percentage for purposes of determining the "vintage year" base erosion percentage, the final regulations retain the approach contained the 2018 proposed regulations. Treasury asserted that "[b]ecause Congress chose to determine the base erosion percentage on an aggregate basis, it follows that one aggregate group member's deduction can affect the base erosion percentage that will apply with respect to another member of the group."

KPMG observation

The vintage year approach to computing the base erosion percentage of an NOL will require taxpayers to track separately the base erosion percentage of NOLs based on the year in which the NOLs arose. Applicable taxpayers that are part of an aggregate group will have to track their base erosion percentages by reference to the aggregate group. Treasury received at least one comment requesting elective use of the taxpayer's current year base erosion percentage with respect to target companies that join the taxpayer's aggregate group by acquisition to reduce potential complexity around determining the target entity's vintage year base erosion percentage; Treasury rejected this request and argued that the acquiring corporation should be able to obtain the information necessary to determine the target corporation's vintage year base erosion percentage in the acquisition.

Base erosion minimum tax amount ("BEMTA")

General rules

Subject to only a few modifications, the final regulations largely adopt the language found in the 2018 proposed regulations. An applicable taxpayer's BEMTA for a particular tax year equals the excess of (1) (i) the applicable tax rate for the tax year (the "BEAT Rate") x (ii) MTI **over** (2) the taxpayer's adjusted regular tax liability. For these purposes, an applicable taxpayer's adjusted regular tax liability generally is equal to its regular tax liability, reduced by certain credits allowed against its regular tax liability (but not below zero). Credits that reduce regular tax liability for these purposes cause an offsetting increase in the BEMTA; conversely, credits that do not reduce regular tax liability for these purposes do not cause such an increase in the BEMTA.

For tax years beginning after December 31, 2017, and beginning before January 1, 2026, the statute provides that the following credits do not reduce regular tax liability for BEMTA purposes: (1) the credit allowed under section 38 for the tax year that is properly allocable to the research credit; and (2) a portion equal to 80% of the lesser of (a) the applicable section 38 credits (the low housing credit under section 42(a), the renewable electricity production credit under section 45(a), the investment credit under section 46, but only to the extent properly allocable to the energy credit under section 48), or (b) the BEMTA (determined without regard to the amounts in (2)(a)). Number (2) requires parallel computations.

To prevent an inappropriate understatement of a taxpayer's adjusted regular tax liability (and thus an inappropriate increase in a taxpayer's BEMTA), the 2018 proposed regulations added a third category of tax credits that do not decrease regular tax liability. Specifically, the 2018 proposed regulations provided that credits for overpayment of taxes (section 33) and taxes withheld at source (section 37) are also not subtracted from the taxpayer's regular liability for BEMTA purposes. The final regulations retain these additions and also add to this taxpayer beneficial list section 53 credits for the taxpayer's prior year minimum tax liability.

For tax years beginning after December 31, 2025, the only credits that do not reduce regular tax liability are credits under sections 33, 37, and 53.

KPMG observation

While treatment of the refundable portion of AMT credits as credits that do not reduce regular tax liability was relatively clear, the expansion of that treatment to the nonrefundable portion of such credits is a significant and taxpayer favorable change.

BEAT rate

For taxpayers other than certain banks and securities dealers, the BEAT rates are:

- 5%, for tax years beginning in calendar year 2018;
- 10%, for tax years beginning in calendar year 2019 through tax years ending before January 1, 2026;
- 12.5%, for tax years beginning after calendar year 2025; and
- Taxpayers with a fiscal tax year beginning in 2024 and ending in 2025 are subject to a section 15 blended rate using the 10% rate for the number of days that fall within 2024 and the 12.5% rate for the number of days that fall within 2025.

For a taxpayer that is a member of an affiliated group that includes a bank or a registered securities dealer, these rates are increased by one percentage point to 6%, 11%, and 13.5%, respectively. This increase does not, however, apply to a taxpayer that is part of an affiliated group with de minimis banking and securities dealer activities.

The 2018 proposed rules could have been interpreted as applying a section 15 blended tax rate to a fiscal year taxpayer with a tax year beginning in 2018 and ending in 2019. If the language used in the 2018 proposed regulations created any uncertainty in this regard, the instructions to Form 8991 (*Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*) erased any doubt with respect to Treasury's interpretation of the 2018 proposed regulations, making it clear that Treasury expected fiscal year taxpayers that have a tax year beginning in 2018 and ending in 2019 to apply the section 15 blended rate rules for that year. Based on comments criticizing this interpretation, Treasury reversed course on this point. The final regulations provide that the section 15 blended rate applies only with respect to fiscal tax years beginning in 2024 and ending after 2024.

KPMG observation

A fiscal taxpayer with a tax year beginning in 2018 and ending in 2019 that filed a tax return computing BEAT liability based on a blended rate may wish to consider filing an amended return to recalculate their overall BEAT liability.

In the preamble to the final regulations, Treasury indicated that they received various comments requesting rules that would permit taxpayers to elect to calculate their BEMTA on an aggregate group, consolidated group, or individual company basis. The final regulations rejected all such comments and reiterate that the computation of BEMTA (and MTI) is done on a taxpayer-by-taxpayer basis. Treasury generally noted that if taxpayers calculated BEMTA differently, it could lead to inequitable results among otherwise similar taxpayers and would add significant complexity to the rules.

Partnership transactions

General rules

Consistent with the 2018 proposed regulations, the final regulations generally adopt an aggregate approach to partnerships for purposes of section 59A. In response to comments, the final regulations provide several new rules that clarify how the general aggregate approach to partnerships applies to certain types of partnership transactions, including transfers of property by or to partnerships, transfers of partnership interests by a partner, contributions of property to partnerships, and certain distributions of property by partnerships. The final regulations further provide that if a transaction is not specifically described in the regulations, the determination of whether the transaction gives rise to a base erosion payment or base erosion tax benefit ("BETB") is made in accordance with the aggregate principles of the regulations and the purposes of section 59A.

KPMG observation

Prop. Reg. section 1.59A-7 in the 2018 proposed regulations is rather brief and provides limited guidance for determining base erosion payments and BETBs in connection with partnership transactions. Reg. section 1.59A-7 provides detailed operating rules, along with nine examples that illustrate the application of the final rules. In general, the final regulations expand on the aggregate approach to partnerships set forth in the 2018 proposed regulations.

Partnership transactions that may give rise to base erosion payments

As discussed in the applicable taxpayer section above, for purposes of determining whether a taxpayer has made a base erosion payment, the taxpayer generally must treat a payment to or from a partnership as made to or from each partner. The final regulations provide specific rules for determining the extent to which a partner has made or received a payment in certain situations.

Contributions of property to partnerships

Similar to the 2018 proposed regulations, the final regulations treat a contribution of property to a partnership in exchange for a partnership interest in a transaction that otherwise qualifies for nonrecognition under section 721(a) as a transaction that may give rise to a base erosion payment. The final regulations use a broad application of the aggregate theory of partnerships to treat the contribution as a transaction between the partners to determine whether it gives rise to a base erosion payment.

KPMG observation

The preamble to the 2018 proposed regulations indicated that the aggregate treatment of partnerships resulted in a deemed base erosion payment when a contribution was made to the partnership under section 721, and described this result as "consistent with the approach taken [by the 2018 proposed regulations] with respect to subchapter C transactions"—presumably referring to the fact that contributions to a corporation under section 351 were likewise treated as base erosion payments under the 2018 proposed regulations. Despite the fact that the final regulations generally reverse that position as to subchapter C nonrecognition events, the final regulations continue to treat contributions and other subchapter K nonrecognition transactions as giving rise to base erosion payments via a remarkably broad application of the aggregate theory of partnerships. The preamble acknowledges that this causes equivalent transactions, which vary only in the choice of entity, to give rise to disparate results, but describes the rule as "necessary to align the treatment of economically similar transactions."

Under the final regulations, therefore, if a partner (either a new or existing partner) contributes property to a partnership in exchange for an interest in the partnership, the transaction is treated for purposes of section 59A as if the contributing partner transferred a portion of the contributed property (and assumed any liabilities associated with the transferred partnership interest) to each existing partner in exchange for a portion of the existing partner's pre-contribution interests in the partnership's assets (and the partner's assumption of any liabilities transferred to the partnership). The partnership's assets for this purpose include the property contributed by the contributing partner and any other assets that are contributed at the same time.

Each partner whose proportionate share in a partnership asset (including the assets contributed to the partnership as part of the transaction) is reduced as a result of the transaction is treated as transferring the asset to the extent of the reduction, and each person who receives a proportionate share or an increased proportionate share in an asset as a result of the transaction is treated as receiving an asset to the extent of the increase, proportionately from the partners' reduced interests.

KPMG observation

The final regulations provide an example of the application of this rule: If a person contributes property to a partnership in which each of two existing partners has a 50% pro-rata interest in the partnership in exchange for a one-third pro-rata partnership interest, each of the pre-contribution partners is treated as transferring a one-third interest in its share of existing partnership assets to the contributing partner, and the contributing partner is treated as transferring a one-third interest in the contributed assets to each of the original partners. Thus, if the existing partners in this example are domestic corporations and the new partner is a related foreign corporation that contributes depreciable property, the existing partners' deemed exchanges of a portion of their partnership assets for a portion of the related foreign corporation's contributed property will be a base erosion payment. As a result, deductions for the contributed property that are allocated to the domestic corporate partners generally will be BETBs. As noted above, this is the result under the final regulations even though corporate nonrecognition transactions generally are not treated as base erosion payments that can give rise to BETBs. Perhaps the distinction driving this result (although not made fully explicit in the preamble) is the fact that even under the "traditional method" of section 704(c) a non-contributing partner can effectively access full basis in built-in gain contributed property (in the example above this would be the case as long as the appreciation in the contributed property did not exceed one-third of the overall value of the property—i.e., the continuing proportionate interest of the contributing partner).

Transfers of certain property by, or to, partnerships

If a partnership transfers property, each partner is treated as transferring its proportionate share of the property transferred for purposes of determining whether the recipient of the property has a base erosion payment. Similarly, if a person transfers property to a partnership, each partner is treated as acquiring its proportionate share of the property from the transferor for purposes of determining whether the partner has a base erosion payment.

If a partner (that is not itself a partnership) transfers an interest in a partnership, the partner generally is treated as transferring its share of the partnership's assets to the recipient. If a partnership transfers an interest in a partnership, each partner whose proportionate share of assets is reduced is treated as transferring a share of partnership assets equal to the amount of the reduction.

A transfer of a partnership interest for these purposes includes any issuance of a partnership interest by a partnership; any sale of a partnership interest; any increase or decrease in a partner's proportionate share of any partnership asset as a result of a contribution of property or services to a partnership, a distribution, or a redemption; or any other transfer of a proportionate share of any partnership asset (other than a transfer of a partnership asset that is not a partnership interest by the partnership to a person not acting in a partner capacity), whether by a partner or the partnership (including as a result of a deemed or actual sale or a capital shift).

KPMG observation

The purchase of a partnership interest from a related foreign partner by an applicable taxpayer (or by a partnership with an applicable taxpayer partner) constitutes a base erosion payment to the related foreign partner for the selling partner's proportionate share of partnership assets. To the extent those partnership assets include depreciable or amortizable properties, the purchase can result in the allocation of depreciation or amortization that constitutes a base erosion tax benefit. This means that the BEAT provisions can become applicable even to "old and cold" partnerships that have only purchased depreciable property from third parties in years prior to the enactment of section 59A. In addition, if the partnership has a section 754 election in effect, or there is otherwise a mandatory basis adjustment, any depreciation or amortization on the resulting section 743(b) adjustment resulting from such a purchase would also constitute a BETB to the acquiring related partner.

Partnership distributions that increase asset basis

If a partnership distributes property to a foreign related party and the basis in the remaining partnership property is increased, for example under section 734(b), then the taxpayer's share of the increased basis in the partnership property is treated as newly purchased property acquired by the taxpayer from the foreign related party that is placed in service when the distribution occurs. The increased basis is treated as acquired with a base erosion payment, unless an exception applies. If a partnership distributes property to a taxpayer and the basis in the property is increased, for example under section 732(b), the increased basis in the distributed property is treated as newly purchased property acquired by the taxpayer from a foreign related-party partner in proportion to the foreign related party's proportionate share of the asset immediately before the distribution. This increased basis treated as newly purchased property is treated as acquired with a base erosion payment, unless an exception applies. If the distribution is to a person other than a taxpayer or a foreign related party, there is no base erosion payment caused by the distribution under these rules.

KPMG observation

These transactions can result in multiple sets of computations to measure the base erosion payments of a partner. Non-pro rata distributions, for example, can result in both a section 734(b) step up to remaining partnership property and an increase in the proportionate share of remaining assets that non-distributee partners are deemed to acquire from the distributee partner for purposes of section 59A, both of which may constitute a base erosion payment.

The regulations provide an example of this involving a partnership that is owned equally by three partners—two related parties (domestic corporation DC and foreign corporation FC) and an unrelated third party (UC). The partnership holds only one asset—a depreciable property with an adjusted basis of $60. The partnership redeems out FC with cash, resulting in gain of $40 to FC. The first step of the transaction results in a base erosion payment being made to FC as the partnership had a section 754 election in effect and received a $40 basis adjustment under section 734(b) to the partnership's depreciable property. DC will recognize a BETB equal to its share of depreciation allocated to it from the $40 section 734(b) basis adjustment. In addition, the transaction results in a second base erosion payment to FC as DC's proportionate interest in partnership property increased from 33% to 50%. DC's proportionate share of the pre-transaction $60 tax basis in the property increased, therefore, from $20 to $30. This additional 1/6th interest in the partnership property is deemed acquired from FC. DC shall recognize a BETB equal to the depreciation it is allocated that is attributable to this interest.

Determination of base erosion tax benefits for partners

A partner's distributive share of any deduction or reduction in gross receipts attributable to a base erosion payment (including as a result of sections 704(b) and (c), 707(a) and (c), 732(b) and (d), 734(b) and (d), 737, 743(b) and (d), and 751(b)) generally is the partner's BETB.

KPMG observation

The final regulations note that a partner's BETB may be more than the partner's base erosion payment. For example, if a partnership purchases depreciable property from a foreign corporation that is a related party of a domestic corporate partner, and the partnership specially allocates more depreciation deductions to a partner than its proportionate share of the asset, the partner's BETB includes the specially allocated depreciation deduction, even if the total allocated deduction exceeds the partner's share of the base erosion payment made to acquire the asset. BETBs are determined separately for each asset, payment, or accrual, as applicable, and are not netted with other items.

This provision can extend to situations that do not involve special allocations, but that instead involve common arrangements where the partners have varying interests in partnership profits and losses due to preferred returns or income tranches that are shared differently. As such, a partner's BETB may vary widely from its share of the base erosion payment that was made to acquire the asset. For example, consider a fact pattern where two partners contribute capital 50/50, but one partner, A, has an entitlement to a $10 preferred return of income before the partners share residual profits 50/50. Assume that partnership acquires $50 of property from a foreign related party of Partner A that is depreciable over five years, generating $10 of depreciation each year. If the partnership earns $10 in a year, A's associated BETB is 100% of the $10 of tax depreciation from the property for that year (as A is allocated 100% of the taxable income, which includes all of the tax depreciation). If, instead, the partnership earns $20 in a year, A's associated base erosion tax benefit is $7.50, as A would be allocated 75% of the partnership's taxable income for the year (which includes 75% of the $10 tax depreciation).

The examples in the regulations illustrate that remedial deductions allocated to a partner with respect to property considered acquired from a related foreign party are considered BETBs. This is consistent with the general rules in the section 704(c) regulations that provide that remedial allocations of income, gain, loss, or deduction to the noncontributing partner have the same tax attributes as the item being limited by the ceiling rule. However, neither the regulations nor the examples specifically discuss the treatment of deductions allocated to the non-contributing partner to cure a ceiling rule limitation in a situation when the partnership is using the traditional with curative method to account for allocations under section 704(c). When the traditional with curative method is used, the partnership can generally allocate other deductions that would have gone to the contributor instead to the noncontributing partner to cure any ceiling rule limitation with respect to a particular property. However, the regulations require that to be reasonable, a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. The reference for the need to extend the rule to income allocations, however, could conceivably be read as suggesting that the rules would otherwise permit curative allocations using deductions from other property (not acquired from a related foreign party) and that such allocations can therefore be made provided the partner treats the curative deductions as similarly resulting in BETBs.

2019 proposed regulations

Allocations by a partnership of income instead of deductions

The 2019 proposed regulations contain a proposed rule that would treat income allocations to a contributing partner as deductions in certain situations. Specifically, if a partnership adopts the curative method of making section 704(c) allocations, the allocation of income to the contributing partner in lieu of a deduction allocation to the noncontributing partner would be treated as a deduction for purposes of section 59A in an amount equal to the income allocation. The preamble to the 2019 proposed regulations explains that Treasury is aware that a partner in a partnership can obtain a similar economic result if the partnership allocates income items away from the partner through curative allocations instead of allocating a deduction to the partner. Accordingly, to the extent the partnership allocates less income to a partner due to curative allocations in lieu of allocating a deduction to the partner, the proposed regulations provide that the partner is similarly treated as having a deduction to the extent of that substitute allocation, which may be a BETB. The 2019 proposed regulations provide an example of the application of this rule.

KPMG observation

The government appears to believe the proposed addition of this rule to be necessary for two reasons. First, an income allocation as described in the 2019 proposed regulations otherwise would not meet the definition of a BETB. Second, an income allocation to a contributing partner may not otherwise have had the same tax impact on the contributing partner as the item that was subject to the ceiling rule limitation (i.e., treatment as BETB). Absent a provision that treats it otherwise, it may have been difficult to make the use of income to offset a ceiling rule limitation under the general reasonableness standard applicable to the traditional with curative method. Income allocations under the curative method can vary in character only if gain on the sale of the property subject to the curative method is used, and the partnership agreement provides for this allocation. Outside of this exception, the item used to cure the ceiling rule distortion must have substantially the same impact on the contributing partner's tax liability as the item being cured.

Request for ECI exception

The preambles to the final regulations and the 2019 proposed regulations state that Treasury received comments recommending that contributions of depreciable or amortizable property by a foreign related party to a partnership (in which an applicable taxpayer is a partner), or distributions of depreciable or amortizable property by a partnership (in which a foreign related party is a partner) to an applicable taxpayer, be excluded from the definition of a base erosion payment to the extent that the foreign related party would receive (or would be expected to receive) allocations of income from that partnership interest that would be taxable to the foreign related party as ECI.

Treasury declined to adopt this recommendation in the final regulations, but Treasury is considering additional guidance to address the treatment of a contribution by a foreign person to a partnership engaged in a U.S. trade or business, transfers of partnership interests by a foreign person, and transfers of property by the partnership with a foreign person as a partner to a related U.S. person. Treasury requested comments regarding how these issues should be addressed, including rules to ensure that the foreign partner is treating the items allocated with respect to the property and any gain from the property as ECI.

Partnership anti-abuse rules

The 2019 proposed regulations would add two new anti-abuse rules regarding derivatives on partnership interests and allocations by a partnership to prevent or reduce a base erosion payment. Those rules are discussed in the anti-abuse rule section, below.

Partnership reporting

The preamble to the 2019 proposed regulations states that the IRS plans to update Form 1065, Schedule K, and Schedule K-1 to incorporate certain information that domestic partnerships and foreign partnerships with ECI will need to report to their partners to allow them to complete their Form 8991 or a successor form. The IRS expects that these revisions to Form 1065, Schedule K, and Schedule K-1 will track the information required by Form 8991.

The 2019 proposed regulations also would amend the regulations under section 6031 to require reporting by certain partners in a foreign partnership when the foreign partnership is not required to file Form 1065. Specifically, if a foreign partnership is not required to file a partnership return and the foreign partnership has made a payment or accrual that is treated as a base erosion payment of a partner, a person required to file Form 8991 (or successor) who is a partner in the partnership generally would be required to provide the information necessary to report any base erosion payments on Form 8991 (or successor) under the related instructions.

Anti-abuse rules

Final regulations

Section 59A(i) provides Treasury with extremely broad anti-abuse authority, but the 2018 proposed regulations provided a number of specific anti-abuse rules addressing relatively narrow factual situations, as well as three general anti-abuse rules focused on specific transactions, plans, or arrangements that have a principal purpose of avoiding section 59A. The final rules adopt the three general anti-abuse rules from the 2018 proposed regulations and, in response to taxpayer comments, add new examples aimed at clarifying the "principal purpose" standard and treatment of ordinary course transactions.

In addition, the final rules add a fourth anti-abuse rule, dealing with nonrecognition transactions. Under the new anti-abuse rule, if a transaction (or series of transactions), plan, or arrangement has a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in a specified nonrecognition transaction, then the specified nonrecognition transaction will not qualify for the exception from being a base erosion payment. If a transaction (or series of transactions), plan, or arrangement between related parties increases the adjusted basis of property within six months prior to the specified nonrecognition transaction, the requisite principal purpose is deemed to exist.

KPMG observation

The per se rule for basis step-up transactions prior to a specified nonrecognition transaction only applies to transactions (or plans or arrangements) between related parties. Transactions with unrelated parties may still fall under the anti-abuse rule if they have a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in a specified nonrecognition transaction. It is not clear how this principal purpose test would apply in the context of deciding how to structure an acquisition from an unrelated party.

Partnership anti-abuse and recharacterization rules

The 2019 proposed regulations provide two additional anti-abuse rules applicable to partnerships. The first rule relates to derivatives on partnership interests or partnership assets, and would provide that a taxpayer is treated as having a direct interest in the partnership interest or asset if the taxpayer acquires a derivative on a partnership interest or asset with a principal purpose of avoiding or reducing a base erosion payment.

The second rule is aimed at preventing a partnership from allocating items of income with a principal purpose of eliminating or reducing the base erosion payments of a taxpayer not acting in a partner capacity on amounts paid to or accrued by a partnership that do not change the economic arrangement of the partners. The preamble illustrates the proposed rule with an example that assumes that a domestic corporation and a third party both pay equal amounts for services to a partnership with a foreign related-party partner and an unrelated partner (each having equal interests in the partnership). If the partnership allocates the income it receives from the domestic corporation to the unrelated partner while allocating an equivalent amount of income from the third party to the foreign related-party partner with a principal purpose of eliminating the domestic corporation's base erosion payment, the domestic corporation would determine its base erosion payment as if the allocations had not been made and the partners shared the income proportionately. In this case, half of the domestic corporation's payment would be considered a base erosion payment.

KPMG observation

The proposed anti-abuse rule does not operate if the economic arrangement of the partners is changed by the allocation. Thus, not every allocation that might have the effect of allocating BETBs away from a related partner is subject to recharacterization under this anti-abuse rule. Note that the rule provided in the 2019 proposed regulation does not require that the partnership alter its allocations in the case of an allocation that was subject to the anti-abuse rule. Rather, the 2019 proposed regulations provide that the taxpayer transacting with the partnership is required to determine its base erosion payment as if the allocations had not been made and the items of income had been allocated proportionately. Presumably, the determination of whether the partnership allocation that was actually made was valid remains subject to the regular rules of section 704(b). Given that the special allocation illustrated in the preamble example would not have impacted the dollars to be received by the partners independent of tax consequences, one might worry that the general rule of the substantiality regulations is sufficient to invalidate the special allocation of the example. The suggestion in the preamble that the anti-abuse rule is necessary to prevent the avoidance of BEAT indicates that the government does not necessarily believe that to be the case. There is additional uncertainty as to whether a reallocation under the section 704(b) rules would always equal a "proportionate" allocation of the payment that the transacting taxpayer is required to use in determining its base erosion payments. Neither the proposed nor final regulations define what the word "proportionate" means, and all examples provided involve straight up partnerships where the partners share in profits, loss and capital in the same ratios.

Treatment of consolidated groups

The 2019 final regulations generally adopt the rules contained in the 2018 proposed regulations on the application of the BEAT to consolidated groups. The regulations state that all members of a consolidated group are treated as a single taxpayer for purposes of determining whether the group is an applicable taxpayer and the amount of tax due under section 59A. Accordingly, the 2018 proposed regulations provided that items resulting from intercompany transactions (as defined in Reg. section 1.1502-13(b)(1)(i)) are disregarded for purposes of making determinations under the BEAT. In response to questions about how this works, the final regulations clarify the language in Reg. section 1.1502-59A(b)(1) to say that such items are not taken into account in computing the group's base erosion percentage and BEMTA. Thus, for example, if depreciable property is acquired by a member of a consolidated group from a related foreign party, and then sells that property when it has appreciated to a second member of the group, any depreciation deductions allowed to the second member in excess of what the first member would have been allowed are not taken into account in determining the group's base erosion percentage or BETBs.

The final regulations also provide relief in certain situations in which a member of the consolidated group that has a disallowed business net interest expense ("BIE") carryforward under section 163(j) leaves the group. The final regulations adopt the intricate rules of the 2018 proposed regulations for coordinating the BEAT rules with the proposed section 163(j) regulations for a consolidated group. In general, to the extent a consolidated group's BIE is allowed as a deduction in a tax year, it is classified first as from BIE paid/accrued to a foreign related party and a domestic related party, on a pro rata basis, with any remaining BIE deductions treated as BIE paid/accrued to an unrelated party. Under complex rules, this allocation is done on a consolidated basis, and a member's current year BIE can be classified (and thus treated) as (i) domestic-related current year BIE, (ii) foreign-related current year BIE, or (iii) both, regardless of whether the member actually incurred BIE on debt owed to a domestic or foreign related party. These classification rules apply on a year-by-year basis, and the classification of BIE as foreign related party BIE or domestic related party BIE (or if neither, as unrelated party BIE) effectively persists with the BIE, even if it becomes part of a section 163(j) disallowed BIE carryforward.

The final regulations adopt a rule from the 2018 proposed regulations that provides that when a member departs a consolidated group, the member's disallowed BIE carryforwards generally retain their allocated status (i.e., as having been paid/accrued to a domestic or foreign related party or to an unrelated party). Similarly, the final regulations provide that if a member's assets are acquired in a section 381(a) transaction (such as a tax-free section 368(a)(1) asset reorganization or section 332 subsidiary liquidation), the member's disallowed BIE carryforwards are inherited and retain their allocated status. This retained status is taken into account in determining an acquiring group's base erosion tax benefit when the disallowed BIE carryforwards are utilized by the acquiring group. The government generally rejected comments that the persistence of the character of a disallowed BIE carryforward was too complex (or that the information necessary to make a relevant determination may not be available) when the group from which the member departs is not an applicable taxpayer. The preamble to the final regulations points out that the allocation of BIE between the different categories will be necessary for a taxpayer to determine whether the consolidated group meets the base erosion percentage test for the year in which the BIE is paid/accrued, and accordingly making the allocation is part of determining whether the consolidated group is an applicable taxpayer.

The final regulations provide a special rule for a deconsolidating corporation with a disallowed BIE carryforward if the group from which it departed was not an applicable taxpayer by reason of the gross receipts test (in which case it would have been unnecessary to determine the base erosion percentage for the group and accordingly the disallowed BIE carryforwards would not have needed to be allocated among categories). The final regulations allow the deconsolidating member (and any acquiring consolidated group) to apply the classification rule on a separate-entity basis to determine the status of the deconsolidating member's disallowed BIE carryforward as a payment/accrual to a domestic related, foreign related, or unrelated party. However, if the deconsolidating member (or its acquiring consolidated group) fails to substantiate the status of its disallowed BIE carryforwards from the original group, the disallowed BIE carryforward is treated as a payment or accrual to a foreign related party.

The preamble to the 2019 proposed regulations indicates that taxpayers have raised concerns about the treatment of intercompany items upon the deconsolidation of a member of a consolidated group that then joins a different aggregate group. The preamble indicates that these issues will be addressed in future regulations and requests comments.

KPMG observation

A problem similar to the one addressed with regard to disallowed BIE carryforwards exists for corporations that incurred NOL carryforwards at a time when they were not applicable taxpayers by reason of the gross receipts test. The final regulations do not, however, contain a safe harbor like that provided in the case of disallowed BIE carryforward.

Applicability dates and reliance

The **final regulations** (other than the reporting requirements for QDPs in Reg. sections 1.6038A-2(b)(7), 1.1502-2, and 1.1502-59A) apply to tax years ending on or after **December 17, 2018**. Taxpayers are also permitted to apply the final regulations in their entirety for tax years ending before December 17, 2018, but must do so consistently and cannot selectively choose which particular provisions to apply. Taxpayers also may rely on the 2018 proposed regulations in lieu of the final regulations for all tax years ending on or before December 6, 2019, provided the taxpayer applies the 2018 proposed regulations in their entirety (subject to the discussion below).

The **2019 proposed regulations** have multiple effective dates. The rules in Prop. Reg. sections 1.59A-7(c)(5)(v) (regarding partnership allocations in lieu of deductions), 1.59A-9(b)(5) (anti-abuse—partner derivative rule) and (6) (anti-abuse—allocation to eliminate or reduce base erosion payment) apply to tax years ending on or December 2, 2019. The rules in Prop. Reg. sections 1.59A-2(c)(2)(ii) and (c)(4) through (6) (for determining applicable taxpayer status) and 1.59A-3(c)(5) and (6) (relating to the waiver of deductions) apply to tax years beginning on or after December 6, 2019. Taxpayers are expressly permitted to rely on the 2019 proposed regulations in their entirety for tax years beginning after December 31, 2017, and before the final regulations are applicable. If a taxpayer chooses to apply both the 2019 proposed regulations and the 2018 proposed regulations to a tax year ending on or before December 6, 2019, the taxpayer is not required to apply aggregate group rules in Prop. Reg. sections 1.59A-2(c)(2)(ii), (c)(4), (c)(5), and (c)(6) to that tax year.

KPMG observation

The applicability date provisions offer significant flexibility to taxpayers. In particular, taxpayers wishing to apply the 2019 proposed regulations (including the election to waive deductions) to their 2018 tax year are able to do so, regardless whether they otherwise file in reliance on the 2018 proposed regulations or on the basis of the final regulations.

Comment period and hearing

Comments or requests for a public hearing on the 2019 proposed regulations must be received by February 4, 2020.

Contact us

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