

Treasury Drops the BEAT—Final Base Erosion and Anti-Abuse Tax Regulations

December 11, 2019

Treasury and the IRS have released long-awaited Final Regulations on the base erosion and anti-abuse tax (BEAT) introduced in the 2017 tax reform legislation, as well as New Proposed Regulations on a handful of technical BEAT topics. While these regulations make a few changes that will be helpful to taxpayers, the Final Regulations mostly adopt the rules set out in the Proposed Regulations without any changes. As a result, the BEAT rules will apply in an inflexible way to a number of transactions, with far-reaching consequences.

The BEAT rules impose a 10% minimum tax that applies if a U.S. company makes a deductible “base erosion payment” to a foreign affiliate (the 10% rate rises to 12.5% in 2026). Payments subject to the BEAT include interest, purchases of depreciable assets and certain reinsurance payments that reduce gross income. There are exceptions for qualifying derivative payments, services provided at cost and payments subject to U.S. withholding tax.

The BEAT applies to a U.S. corporation if average annual gross receipts (tested on a group basis taking into account U.S. affiliates and U.S. branches of foreign affiliates) exceed \$500M for the prior three years, and if base erosion payments to non-U.S. affiliates are at least 3% of total deductions (2% for groups that include a bank or registered securities dealer).

The Final Regulations are generally effective on December 6, 2019. The New Proposed Regulations will not be effective until issued in final form, but once finalized, they will generally (with a few exceptions) apply for taxable years beginning after December 31, 2018. In the meantime, taxpayers may rely on the Proposed Regulations, but only if the taxpayer and all related parties apply the regulations consistently.

FINAL AND PROPOSED REGULATIONS

Determining the BEAT

- The Final Regulations clarify how the BEAT (and its underlying components) is calculated. In particular, the Final Regulations set out a “**with-or-within**” method for determining the gross receipts and the base erosion percentage of a taxpayer’s group. This method looks to the taxpayer’s taxable year and the taxable year of each member of its aggregate group that ends with or within the applicable taxpayer’s taxable year.

Comment: Each company in a group must determine its own aggregate group BEAT test. As a result, in M&A activity, the new rules require tax year cutoffs for the target and all other members of the selling and buying and group. The New Proposed Regulations allow taxpayers to choose a closing of the books or a pro rata allocation.

- The Final Regulations and New Proposed Regulations expand on BEAT calculations in the context of partnerships and partners. The Final Regulations generally apply an aggregate approach, under which contributions to, and distributions from, partnerships are treated as transactions between partners for BEAT purposes. The rules can apply if a U.S. taxpayer and a related foreign entity are both partners of a partnership.
 - For example, under the Final Regulations, a contribution of property to a partnership is treated as a transaction between the contributor and the other partners—which could be a base erosion payment if a U.S. partner is treated as acquiring depreciable property from a related foreign partner.

Comment: If applicable, these rules could be quite burdensome, requiring common partnership transactions to be recharacterized and separately analyzed for BEAT purposes. The Final Regulations include a limited small partner exception, which does not apply if a partner’s interest has a fair market value of \$25M or more.

Waiving of Deductions to Stay out of the BEAT

- The New Proposed Regulations allow taxpayers to elect to waive deductions to stay below the base erosion percentage threshold. This election is made on an annual basis, and can be changed from year to year. However, waived deductions must be waived for all tax purposes, subject to technical exceptions designed to prevent taxpayers from benefiting from waived deductions in future years.

Comment: The option to waive certain deductions is welcome and will be beneficial for taxpayers on the cusp of being subject to the BEAT. Waiving deductions may allow such taxpayers to avoid a “cliff effect” of substantial BEAT.

No Relief for Profit Split Transfer Pricing Arrangements

- The Final Regulations do not provide an exception for a U.S. corporation that receives payments from an unrelated customer and then makes payments to a foreign affiliate pursuant to a profit split method under the U.S. transfer pricing rules.

Comment: Taxpayers had requested relief for this type of arrangement because the result is economically similar to the customer making payments to the U.S. corporation and its foreign affiliate directly. Taxpayers in this situation should consider revising their arrangements so that payments are made directly to foreign affiliates or so that the U.S. group company acts as an agent making payments on behalf of the customer.

The BEAT and Corporate Transactions

- The Proposed Regulations contained a harsh rule under which a domestic corporation’s acquisition of depreciable property from a related foreign person in a non-recognition transaction constituted a base erosion payment, and would thus subject the resulting depreciation deductions to the BEAT. The Final Regulations have a more moderate rule under which a domestic corporation’s acquisition of depreciable property in a non-recognition transaction results in a base erosion payment only to the extent the domestic corporation transfers its cash or other property in addition to stock.
- For example, if a domestic corporation acquires depreciable machinery from a foreign related corporation in exchange for stock and cash “boot” in a Section 368 reorganization, the use of stock is not, but the use of boot is, a base erosion payment. As another example, if a domestic corporation transfers cash to a foreign subsidiary in exchange for the subsidiary’s stock and depreciable machinery in a Section 351 transaction, the use of cash to acquire the stock is not a base erosion payment, but the use of cash to acquire the machinery is a base erosion payment.
- The Final Regulations say that a distribution from a corporation (regardless of whether the distribution is out of earnings and profits) is not a base erosion payment because **no property is surrendered** in connection with a pure dividend. As a result, a domestic corporate shareholder’s receipt of depreciable property in an in-kind distribution from a related foreign corporation is not a base erosion payment. However, **if the transaction is an exchange under 302**, the exchange is treated as a base erosion payment because the domestic corporate shareholder surrenders shares

in the foreign distributing corporation, even if the redemption is taxable under Section 302(d) as a dividend.

- The Final Regulations do not exclude from the definition of a base erosion payment payments made by a domestic corporation to a controlled foreign corporation (CFC), even if U.S. shareholders pay tax currently on this income under the CFC rules. Taxpayers had requested this exception, but Treasury rejected the request.

No Netting Rule Continues to Apply, Including for Reinsurance Transactions

- Consistent with the Proposed Regulations, the Final Regulations provide that, if a contract or arrangement requires netting of payments to and from a foreign related party, the BEAT will be imposed on the gross outbound payment, unless a specific exception in the BEAT rules applies (for example, the BEAT rules include a specific exception for qualified derivative payments) or netting applies under generally applicable federal income tax principles (“natural netting”).
- The IRS and Treasury declined to give specific guidance on circumstances where netting is prescribed under general tax principles. The IRS and Treasury did, however, signal their intent to study the effect of these provisions on the BEAT to determine whether any changes need to be made to their application.

New Relief for Reinsurance Claims Payments

- Reinsurance payments from a U.S. insurer to a non-U.S. affiliate reinsurer continue to be subject to the BEAT on a gross basis under the Final Regulations, even if payments of premiums, ceding commissions, expense allowances and reimbursements for losses are settled on a net basis under the terms of the reinsurance contract.

Comment: As was true under the Proposed Regulations, this results in reinsurance by U.S. insurers to non-U.S. affiliates being taxed harshly under the BEAT rules, in some cases with the resulting tax exceeding the net profits from the transaction.

- In a departure from the Proposed Regulations, the Final Regulations create an **exception** to the BEAT for **claims payments by a U.S. reinsurer to a non-U.S. affiliate insurer** for losses under reinsurance contracts if the underlying insured or annuitant is not a related party, even if such payments are otherwise treated as deductions, rather than as reductions in or exclusions from gross income.

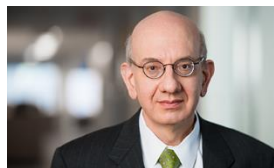
Anti-Abuse Rules

- The Final Regulations generally kept the framework of the Proposed Regulations' anti-abuse rules, but added examples intended to clarify the scope of targeted abuses and a new rule designed to limit BEAT avoidance under the new rules on corporate non-recognition transactions.

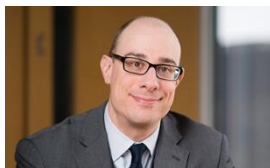
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Please do not hesitate to contact us with any questions.

OFFICE



Gary M. Friedman
gmfriedman@debevoise.com



Peter A. Furci
pafurci@debevoise.com



Peter F.G. Schuur
pfgschuur@debevoise.com



Lillian J. Aston
ljaston@debevoise.com



Samuel M. Duncan
smduncan@debevoise.com



Robert Nelson-Sullivan
rnelsonsullivan@debevoise.com



Cameron E. Rotblat
cerotblat@debevoise.com