

**DEPARTMENT OF THE TREASURY****Internal Revenue Service****26 CFR Part 1**

[TD 9885]

RIN 1545-BO56

**Base Erosion and Anti-Abuse Tax****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations implementing the base erosion and anti-abuse tax, designed to prevent the reduction of tax liability by certain large corporate taxpayers through certain payments made to foreign related parties and certain tax credits. These final regulations also provide reporting requirements related to this tax. This tax was added to the Internal Revenue Code (the “Code”) as part of the Tax Cuts and Jobs Act. This document finalizes the proposed regulations published on December 21, 2018. The final regulations affect corporations with substantial gross receipts that make payments to foreign related parties. The final regulations also affect any reporting corporations required to furnish information relating to certain related-party transactions and information relating to a trade or business conducted within the United States by a foreign corporation.

**DATES:** *Effective date:* The final regulations are effective on December 6, 2019. *Applicability dates:* For dates of applicability, see §§ 1.59A-10, 1.1502-2(d), 1.1502-59A(h), and 1.6038A-2(g).

**FOR FURTHER INFORMATION CONTACT:** Concerning §§ 1.59A-1 through 1.59A-10, Azeka J. Abramoff, Sheila Ramaswamy, or Karen Walny at (202) 317-6938; concerning the services cost method exception, L. Ulysses Chatman at (202) 317-6939; concerning §§ 1.383-1, 1.1502-2, 1.1502-4, 1.1502-43, 1.1502-47, 1.1502-59A, 1.1502-100, and 1.6655-5, Julie Wang at (202) 317-6975 or John P. Stemwedel at (202) 317-5024; concerning §§ 1.6038A-1, 1.6038A-2, and 1.6038A-4, Brad McCormack or Anand Desai at (202) 317-6939 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:****Background**

On December 21, 2018, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG-104259-18) under section 59A, and proposed amendments to 26 CFR part 1 under sections 383, 1502, 6038A, and 6655 in

the **Federal Register** (83 FR 65956) (the “proposed regulations”). The base erosion and anti-abuse tax (“BEAT”) in section 59A was added to the Code by the Tax Cuts and Jobs Act, Public Law 115-97 (2017) (the “Act”), which was enacted on December 22, 2017. The Act also added reporting obligations regarding this tax for 25-percent foreign-owned corporations subject to section 6038A and foreign corporations subject to section 6038C.

A public hearing was held on March 25, 2019. The Treasury Department and the IRS also received written comments with respect to the proposed regulations. Comments outside the scope of this rulemaking are generally not addressed but may be considered in connection with future guidance projects. All written comments received in response to the proposed regulations are available at [www.regulations.gov](http://www.regulations.gov) or upon request.

**Summary of Comments and Explanation of Revisions****I. Overview**

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions discusses those revisions as well as comments received in response to the solicitation of comments in the notice of proposed rulemaking accompanying the proposed regulations.

**II. Comments and Changes to Proposed § 1.59A-1—Overview and Definitions**

Proposed § 1.59A-1 provides general definitions under section 59A. Proposed § 1.59A-1(b)(17) provides a definition of the term “related party.” The proposed regulations generally define a related party with respect to an applicable taxpayer as (a) any 25-percent owner of the taxpayer, (b) any person related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer, or (c) a controlled taxpayer within the meaning of § 1.482-1(i)(5).

The proposed regulations’ definition of “related party” is identical to the definition provided by section 59A(g), except with respect to the relatedness standard under section 482. Specifically, the proposed regulations provide a more precise citation to the section 482 regulations (“a controlled taxpayer within the meaning of § 1.482-1(i)(5)”) than the general cross-reference that is provided in section 59A(g)(1)(C) (“any other person who is related (within the meaning of section 482) to the taxpayer”).

Comments recommended that the final regulations modify the definition

of “related party” to exclude related publicly traded companies or otherwise provide an exception for payments between publicly traded companies. These comments suggested that payments between related publicly traded companies do not result in base erosion. The comments explained that the boards of directors of publicly traded companies generally have fiduciary obligations to shareholders to act in the best interest of the company and are subject to regulatory oversight. On this basis, the comments asserted that a domestic corporation cannot artificially shift profits to a foreign corporation in this situation. Comments also noted that the Treasury Department and the IRS have provided relief for publicly traded companies in circumstances where there is no explicit legislative history or statutory authority to do so, such as where minority shareholders of publicly traded companies must be identified. See § 1.367(e)-1(d)(3) and § 1.382-2T(j).

The Treasury Department and the IRS have determined that it is not appropriate to modify the statutory definition of a related party to exclude publicly traded companies because this recommendation is inconsistent with the statutory language of section 59A(g). Section 59A(g) sets forth specific limits on the definition of a “related party” that include a corporation and its 25-percent owner. Under the proposal recommended by the comments, section 59A would not apply to any less than 100 percent owned affiliate, so long as other “public” shareholders owned some interest in the corporation. The corporate laws of a state of the United States or a foreign jurisdiction may, and often do, impose certain duties on the board of directors of a company, including obligations with respect to the interests of minority shareholders. These companies are also subject to securities laws in the United States. Notwithstanding this regulatory environment, the Code includes many provisions that apply to related parties, and none of those provisions are limited to corporations that are 100 percent related.

For example, section 267(a) generally applies to transactions among greater than 50 percent controlled parties. Section 482 provides a test that can be satisfied by a quantitative measure of ownership or a qualitative test of control (“two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests”), that, as interpreted by regulations, can apply at well below a 100 percent relatedness standard. See § 1.482-1(i)(5). Other sections of the

Code apply based on a relatedness standard of 80 percent. *See, generally*, section 1504; section 351(a). In section 59A, Congress adopted, disjunctively, both the 50 percent relatedness-test from section 267(a) and the relatedness-test from section 482. Moreover, Congress also added, disjunctively, a lower objective standard for determining relatedness for a 25-percent owner.

Finally, the Treasury Department and IRS concluded that a rule that confers special status on payments to a publicly traded foreign corporation that is related (using a 25 percent or greater standard) to the payor would not be analogous to the rules in § 1.367(e)–1(d)(3) or § 1.382–2T(j), which provide special rules that pertain to shareholders that own less than 5 percent of publicly traded corporations, in light of challenges in determining the identity of such shareholders.

For these reasons, the final regulations do not modify the relatedness thresholds that are set forth in section 59A and the proposed regulations.

### III. Comments and Changes to Proposed § 1.59A–2—Applicable Taxpayer, Aggregation Rules, Gross Receipts Test, and Base Erosion Percentage Test

Proposed § 1.59A–2 contains rules for determining whether a taxpayer is an applicable taxpayer on which the BEAT may be imposed, including rules relating to the gross receipts test, base erosion percentage test, and the determination of the aggregate group for purposes of applying these tests.

#### *A. Determining the Gross Receipts and Base Erosion Percentage of an Aggregate Group That Includes a RIC, a REIT, or an Entity Treated as a Corporation by Section 892*

Section 59A(e)(1)(A) excludes corporations that are (1) regulated investment companies (“RICs”), (2) real estate investment trusts (“REITs”), or (3) S corporations from the definition of an applicable taxpayer. A comment requested that the final regulations clarify that controlled RICs and REITs are similarly excluded from the aggregate group for purposes of the gross receipts test and base erosion percentage test. The comment implied that the Treasury Department and the IRS did not intend for RICs and REITs to be part of an aggregate group because RICs and REITs are not subject to the BEAT as separate taxpayers. The proposed regulations do not exclude RICs and REITs from membership in an aggregate group. A corporation is an applicable taxpayer if it is not one of the excluded

categories of corporations (RIC, REIT, or S corporation), it satisfies the gross receipts test in section 59A(e)(1)(B), and it satisfies the base erosion percentage test in section 59A(e)(1)(C). The proposed regulations provide that when applying the gross receipts test and the base erosion percentage test with respect to a particular corporation for purposes of section 59A, those tests are applied on the basis of that corporation and members of that corporation’s aggregate group. The proposed regulations define an aggregate group by reference to section 1563(a) in a manner consistent with section 59A(e)(3), which references section 1563(a) indirectly. The section 1563(a) definition refers to controlled groups of corporations, whether brother-sister groups or parent-subsidary groups. Section 1563(c) provides special rules excluding certain categories of stock in a corporation from the aggregation rules in section 1563(a) (for example, certain stock held by an organization to which section 501 applies). None of those provisions exclude the stock of, or held by, a RIC or REIT. Moreover, just as the gross receipts and deductions of non-applicable taxpayers (such as partnerships) can inure to the benefit of an applicable taxpayer (such as a domestic corporation that is a partner in a partnership), so too can the gross receipts and deductions of a controlled RIC or REIT that is a member of a corporation’s aggregate group inure to the benefit of that corporation. Because of these considerations, the final regulations do not adopt this recommendation.

Similarly, another comment requested that the final regulations exclude from the aggregate group foreign government owners of stock of corporations when the foreign government is treated as a corporation under section 892 and the regulations thereunder. The comment cited the exclusion from section 1563(a) of certain stock held by an organization to which section 501 applies, and suggested that a foreign government should be provided similar treatment because a foreign government, like a section 501 organization, does not have private shareholders. In addition, the comment asserted that it cannot be engaged in direct commercial activities with respect to its portfolio companies and that its investment managers consist of separate teams.

The Treasury Department and the IRS have determined that it is not appropriate to provide a regulatory exception from the aggregate group rules for entities that are commonly controlled by a foreign government shareholder and that are treated as

corporations under section 892. Congress provided that the activities of an aggregate group are fully taken into account when applying the gross receipts test and the base erosion percentage test to a corporation. The fact that a common shareholder of a different chain of corporations may be more passive than other common shareholders, or that the common shareholder’s investment teams are within different lines of a management structure does not change the fact the common shareholder has economic interests in the subsidiary corporation that is within the statutory aggregate group definition adopted for section 59A. Accordingly, the final regulations do not adopt this recommendation.

#### *B. Gross Receipts From Certain Inventory and Similar Transactions*

To determine gross receipts, section 59A(e)(2)(B) provides for “rules similar to the rules” of section 448(c)(3)(B), (C), and (D). Accordingly, these final regulations provide rules that are similar to, but not necessarily the same as, the rules of section 448(c)(3) and the implementing regulations. Proposed § 1.59A–1(b)(13) defines the term “gross receipts” for purposes of section 59A by reference to § 1.448–1T(f)(2)(iv), which provides that gross receipts include total sales, net of returns and allowances, and all amounts received for services. Section 1.448–1T(f)(2)(iv) further provides that gross receipts are not reduced by cost of goods sold (“COGS”) or reduced by the cost of property sold if such property is described in section 1221(a)(1), (3), (4), or (5) (types of property excluded from the definition of a capital asset). Separately, § 1.448–1T(f)(2)(iv) provides that gross receipts from the sale of capital assets or a sale of property described in section 1221(a)(2) (relating to property used in a trade or business) are reduced by the adjusted basis of the property sold. Section 1.448–1T(f)(2)(iv) further provides that gross receipts include income from investments, but not the repayment of a loan or similar instrument.

Comments observed that, pursuant to the definition of gross receipts in the proposed regulations, banks that originate and then sell loans are required to include the gross proceeds from the sale of the loan in their gross receipts because banks generally treat loans originated in the ordinary course of business as ordinary assets under section 1221(a)(4). These comments contrasted a situation where a bank originates and holds a loan to maturity, in which case the proceeds the bank receives upon repayment are not

included in gross receipts due to the express exclusion of these amounts contained in § 1.448–1T(f)(2)(iv). The comments recommended that the regulations provide for a separate reduction of gross receipts from the sale of a loan for the basis in loans originated by a bank. Another comment recommended a similar exception for a bank or broker-dealer that holds stocks and bonds in inventory. This comment proposed that final regulations permit banks and broker-dealers to reduce gross receipts from ordinary course sales of stocks and bonds by the basis of these instruments. The comment also observed that the gains or losses recognized with respect to the stocks and bonds are from sales in the ordinary course and may be small relative to the cost basis in the property.

The final regulations do not adopt the approach suggested by these comments. The final regulations continue to define the term “gross receipts” by cross-referencing to § 1.448–1T(f)(2)(iv), and those rules are used to determine how an item is included in gross receipts. The rules in section 59A for implementing the gross receipts test are similar to the rules described in section 448(c). See section 59A(e)(3) (adopting an aggregation rule similar to that in section 448(c)(2)); section 59A(e)(2)(B) (specifically cross-referencing rules similar to section 448(c)(3)(B), (C), and (D) for the treatment of short taxable years, reductions for returns and allowances, and predecessors, respectively); and section 59A(e)(2)(A) (adopting a broad concept of gross receipts, narrowed to exclude gross receipts of a foreign person that are not taken into account in determining income that is effectively connected with the conduct of a trade or business within the United States). Because of this statutory link between section 59A(e)(2) and section 448, the final regulations adopt the definition of gross receipts for purposes of section 59A that is used for section 448 purposes—that is, the definition in § 1.448–1T(f)(2)(iv). Because the Act includes other new rules that cross-reference section 448, the Treasury Department and the IRS are studying section 448 generally and whether changes should be made to the regulations under section 448 to take into account the Act.

#### *C. Determining the Aggregate Group for Purposes of Applying the Gross Receipts Test and Base Erosion Percentage Test*

Section 59A determines the status of a corporation as an applicable taxpayer on the basis of the aggregate group rules by taking into account the gross receipts and base erosion payments of each

member of the aggregate group. However, each taxpayer must compute the amount of gross receipts and base erosion payments for its aggregate group using its own taxable year and based on those corporations that are members of the aggregate group at the end of the taxable year. See section 59(e)(3). Therefore, members with different taxable years may have different base erosion percentages.

#### *1. Members of an Aggregate Group With Different Taxable Years*

The proposed regulations provide rules for determining whether the gross receipts test and base erosion percentage test are satisfied for purposes of section 59A with respect to a specific taxpayer when other members of its aggregate group have different taxable years. See proposed § 1.59A–2(e)(3)(vii). In general, the proposed regulations provide that, for purposes of section 59A only, each taxpayer determines its gross receipts and base erosion percentage by reference to its own taxable year, taking into account the results of other members of its aggregate group during that taxable year. In other words, the gross receipts, base erosion tax benefits, and deductions of the aggregate group for a taxable year are determined by reference to the taxpayer's own taxable year, without regard to the taxable year of the other member. This rule applies regardless of whether the taxable year of the member begins before January 1, 2018; as a result, a taxpayer includes gross receipts, base erosion tax benefits, and deductions of the member even if that member is not subject to section 59A for that taxable year. The proposed regulations adopted this approach to reduce compliance burden through providing certainty for taxpayers and avoid the complexity of a rule that identifies a single taxable year for an aggregate group for purposes of section 59A that may differ from a particular member of the aggregate group's taxable year. As a result, under the proposed regulations, two related taxpayers with different taxable years may compute their respective gross receipts and base erosion percentages for purposes of section 59A by reference to different periods, even though each taxpayer calculates these amounts on an aggregate group basis that takes into account other members of the controlled group. The preamble to the proposed regulations explains that taxpayers may use a reasonable method to determine the gross receipts and base erosion percentage information with regard to the taxable year of the taxpayer when members of the aggregate group of the

taxpayer have a different taxable year. REG–104259–18, 83 FR 65956, 65959 (December 21, 2018).

Comments expressed concern regarding the potential administrative burdens of treating all members of a taxpayer's aggregate group as having the same taxable year as the taxpayer. These comments argued that, in many cases, companies do not maintain monthly accounting records as detailed as they do on a quarterly basis (for publicly traded companies) or an annual basis (for privately held companies). Also, comments noted that this rule does not take into account the effect of deductions that are determined on a yearly basis or subject to annual limitations, such as under section 163(j).

Comments requested that the determination of gross receipts and the base erosion percentage of a taxpayer's aggregate group be made on the basis of 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 (the “with-or-within method”). With respect to members of an aggregate group with different taxable years, the Treasury Department and the IRS appreciate the concerns raised regarding the potential administrative burden of proposed § 1.59A–2(e)(3)(vii) and believe that the approach described in the comments represents a reasonable approach. The final regulations, therefore, adopt the with-or-within method, for purposes of section 59A only, to determine the gross receipts and the base erosion percentage of an aggregate group. See § 1.59A–2(c)(3). In addition, the Treasury Department and the IRS are issuing a notice of proposed rulemaking (the “2019 proposed regulations”) published in the same issue of the **Federal Register** as these final regulations that proposes rules to further address how to implement the with-or-within method, and how to take into account the changing composition of the aggregate group with respect to a particular taxpayer during the relevant periods for applying the gross receipts test and the base erosion percentage test. The final regulations do not include rules on predecessors or short taxable years. Instead, rules relating to these situations have been re-proposed in the 2019 proposed regulations. Until final rules are applicable relating to predecessors or short taxable years, taxpayers must take a reasonable approach consistent with section 59A(e)(2)(B) to determine gross receipts and base erosion benefits in these situations.

## 2. Time for Determining That Transactions Occurred Between Members of the Aggregate Group

The proposed regulations provide that, for purposes of section 59A, transactions that occur between members of the aggregate group that were members of the aggregate group at the time of the transaction are not taken into account for purposes of determining the gross receipts and base erosion percentage of an aggregate group. *See* proposed § 1.59A–2(c). In the case of a foreign corporation that is a member of an aggregate group, only transactions that relate to income effectively connected with the conduct of a trade or business in the United States are disregarded for this purpose. The preamble to the proposed regulations explains that this limitation on the extent to which foreign corporations are included in the aggregate group is intended to prevent payments from a domestic corporation, or a foreign corporation with respect to effectively connected income, to a foreign related person, from being inappropriately excluded from the base erosion percentage test. REG–104259–18, 83 FR 65956, 65957 (December 21, 2018).

A comment requested clarity on determining whether transactions between members of an aggregate group are disregarded. Specifically, the comment requested clarity on whether a transaction is disregarded when both parties to the transaction are members of the aggregate group at the time of the transaction, or whether it is also a condition that both parties to the transaction must also be members of the aggregate group on the last day of the taxpayer's taxable year.

As requested by the comment, the final regulations clarify that a transaction between parties is disregarded for purposes of section 59A 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 taxable year. *See* § 1.59A–2(c)(1).

## 3. Base Erosion Tax Benefits and Deductions of a Member of an Aggregate Group With a Taxable Year Beginning Before January 1, 2018

For purposes of determining the base erosion percentage, comments also expressed concern about including the base erosion tax benefits and deductions of a member when the taxable year of

the member begins before January 1, 2018. The comments noted that this taxable year of the member is not otherwise subject to section 59A because of the effective date in section 14401(e) of the Act. However, one comment agreed with including these base erosion tax benefits and deductions in the aggregate group of a taxpayer for a taxable year of the taxpayer to which section 59A applies.

The Treasury Department and the IRS agree with comments that it is not appropriate for a taxpayer to include base erosion tax benefits and deductions attributable to a taxable year of a member of its aggregate group that begins before the effective date of section 59A when determining the base erosion percentage of the aggregate group. Accordingly, when determining the base erosion percentage of an aggregate group, the final regulations exclude the base erosion tax benefits and deductions attributable to the taxable year of a member of the aggregate group that begins before January 1, 2018. *See* § 1.59A–2(c)(8). This rule avoids requiring members of an aggregate group to calculate their hypothetical base erosion tax benefits for a year in which the base erosion tax benefit rules do not apply.

## 4. Other Comments Regarding the Aggregate Group Rules

Comments also addressed the following issues with respect to the aggregate group rules in the proposed regulations: (1) How to take into account transactions when a member joins or leaves an aggregate group, (2) the treatment of predecessors of a taxpayer, (3) the determination of the aggregate group of a consolidated group, and (4) the treatment of short taxable years. The Treasury Department and the IRS continue to study the recommendations provided in several comments relating to these issues. Therefore, the Treasury Department and the IRS are issuing the 2019 proposed regulations to further address aggregate group issues.

### D. Mark-to-Market Deductions

To determine the base erosion percentage for the year, the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, the aggregate group) must determine the amount of base erosion tax benefits in the numerator and the total amount of certain deductions, including base erosion tax benefits, in the denominator. The proposed regulations provide rules for determining the total amount of the deductions that are included in the denominator of the base erosion percentage computation in the case of

transactions that are marked to market. In determining the amount of the deduction that is used for purposes of the base erosion percentage test, the proposed regulations require the combination of all items of income, deduction, gain, or loss on each marked transaction for the year (“the BEAT Netting Rule”), such as from a payment, accrual, or mark. *See* proposed § 1.59A–2(e)(3)(vi). The BEAT Netting Rule was adopted to ensure that only a single deduction is claimed with respect to each marked transaction and to prevent distortions in deductions from being included in the denominator of the base erosion percentage, including as a result of the use of an accounting method that values a position more frequently than annually.

A comment requested guidance clarifying whether the BEAT Netting Rule applies to physical securities such as stocks, bonds, repurchase agreements, and securities loans with respect to which a taxpayer applies a mark-to-market method of accounting. The comment questioned whether the BEAT Netting Rule should apply to these types of positions. The comment acknowledged that the BEAT Netting Rule produces an appropriate result with respect to derivatives by avoiding double-counting of both a current mark-to-market loss as well as a future payment to which the current loss relates. Unlike in the case of many derivatives, the comment observed that transactions involving stocks, bonds, repurchase agreements, and securities loans generally do not result in a loss of value to the holder of the relevant instrument that is subsequently realized in the form of a payment made by the holder and that effectively gives rise to an offsetting mark-up of the instrument.

To illustrate this observation, the comment provided the following example. On January 1, 2018, a dealer buys one share of stock in Company XYZ for \$100. Then, during 2018, Company XYZ pays dividends of \$1 with respect to the share. On December 31, 2018, the share price of Company XYZ is \$90. Finally, on January 1, 2019, the dealer sells the share of Company XYZ stock for \$90. The comment noted that in the absence of the BEAT Netting Rule, the amount of the dealer's deduction after marking the stock to market on December 31, 2018, would be \$10. With the application of the BEAT Netting Rule, however, the comment noted that the amount of the deduction that will be included in the base erosion percentage denominator is \$9. According to this comment, the BEAT Netting Rule may not be necessary to avoid the double-counting of deductions

in these transactions, and could result in the netting of amounts that would not be netted under section 475 and that are not duplicative of other inclusions or deductions by the taxpayer.

Proposed § 1.59A–2(e)(3)(vi) applies to any position with respect to which the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, a member of the aggregate group) applies a mark-to-market method of accounting. Therefore, the BEAT Netting Rule in the proposed regulations applies to stocks, bonds, repurchase agreements, and securities lending transactions that the taxpayer marks to market, rendering further clarification unnecessary. The Treasury Department and the IRS have determined that the applicability of the BEAT Netting Rule should not be limited in the manner suggested by the comment. In addition to avoiding the double counting that the comment acknowledged, the proposed regulations adopt the BEAT Netting Rule to enhance administrability and reduce compliance burden. That is, having a single rule apply to all transactions that are marked to market will enhance administrability, especially given the challenges in (a) distinguishing the specific financial transactions that should qualify for exclusion; (b) determining whether a distribution or payment received on an excluded instrument is duplicative of other inclusions or deductions; and (c) determining the extent to which a payment ultimately gives rise to an offsetting decline in the value of the instrument. For these reasons, the BEAT Netting Rule in the final regulations does not exclude physical securities.

Another comment recommended that the BEAT Netting Rule should not be mandatory and should instead be included in the final regulations as only a safe harbor. The comment reasoned that section 59A is generally applied on a gross basis and that requiring taxpayers to offset deductions and losses with income and gain when determining the base erosion percentage is inconsistent with a gross approach. The BEAT Netting Rule was adopted to ensure that taxpayers do not overstate the amount of deductions includible in the denominator with respect to transactions subject to a mark-to-market method of accounting. If the BEAT Netting Rule were provided as a safe harbor in the final regulations, as this comment requested, taxpayers could inappropriately inflate the denominator of the base erosion percentage by treating multiple marks as separate deductions. Therefore, the final regulations do not adopt this comment.

As discussed in Part III.D of this Summary of Comments and Explanation of Revisions, the taxpayer must also determine the amount of base erosion tax benefits in the numerator to determine the base erosion percentage for the year. Proposed § 1.59A–3(b)(2)(iii) also applies the BEAT Netting Rule for purposes of determining the amount of base erosion payments that result from transactions that are marked to market. A comment expressed concern that this rule could result in mark-to-market losses being treated as base erosion payments and recommended the withdrawal of proposed § 1.59A–3(b)(2)(iii), although the comment observed that if the Treasury Department and the IRS were to adopt the comment to make the qualified derivative payments (“QDP”) exception available to securities loans (which is discussed in Part VII of this Summary of Comments and Explanation of Revisions), that change would make this issue moot. The Treasury Department and the IRS do not view this concern to be valid, considering that a mark-to-market loss arising from a deemed sale or disposition of a third-party security held by a taxpayer is not within the general definition of a base erosion payment because the loss is not attributable to any payment made to a foreign related party. Rather, the mark-to-market loss is attributable to a decline in the market value of the security. The Treasury Department and the IRS also note that the BEAT Netting Rule will apply primarily for purposes of determining the amount of deductions that are taken into account in the denominator of the base erosion percentage. The Treasury Department and the IRS agree with the comment that the QDP exception of § 1.59A–3(b)(3)(ii) eliminates most mark-to-market transactions from characterization as a base erosion payment, including as a result of the expansion of the QDP exception to apply to the securities leg of a securities loan. See Part VII of this Summary of Comments and Explanation of Revisions for a discussion of the qualification of the securities leg of a securities loan for the QDP exception. Thus, the BEAT Netting Rule will apply only in limited circumstances such as when the taxpayer fails to properly report a QDP. The final regulations therefore continue to apply the BEAT Netting Rule for purposes of determining the amount of base erosion payments that result from transactions that are marked to market.

#### IV. Comments and Changes to Proposed § 1.59A–3—Base Erosion Payments and Base Erosion Tax Benefits

Proposed § 1.59A–3 contains rules for determining whether a payment or accrual gives rise to a base erosion payment and the base erosion tax benefits that arise from base erosion payments.

##### A. How Base Erosion Payments Are Determined in General

Proposed § 1.59A–3(b)(1) defines a base erosion payment as a payment or accrual by the taxpayer to a foreign related party that is described in one of four categories: (1) A payment with respect to which a deduction is allowable; (2) a payment made in connection with the acquisition of depreciable or amortizable property; (3) premiums or other consideration paid or accrued for reinsurance that is taken into account under section 803(a)(1)(B) or 832(b)(4)(A); or (4) a payment resulting in a reduction of the gross receipts of the taxpayer that is with respect to certain surrogate foreign corporations or related foreign persons.

The Conference Report to the Act states that base erosion payments do not include any amounts that constitute reductions to determine gross income including payments for COGS (except for reductions to determine gross income for certain surrogate foreign corporations). Conf. Rep. at 657. The proposed regulations do not contain a provision that expressly provides that amounts paid or accrued to a related foreign person that result in reductions to determine gross income are not treated as base erosion payments (except in the case of certain surrogate foreign corporations). A comment requested that, in order to provide more certainty to taxpayers, the final regulations expressly reflect that payments that result in reductions to determine gross income are not subject to section 59A. In response to this comment, § 1.59A–3(b) has been modified to explicitly clarify that payments resulting in a reduction to determine gross income, including COGS, are not treated as base erosion payments within the meaning of section 59A(d)(1) or (2). See § 1.59A–3(b)(2)(viii).

The proposed regulations do not establish any specific rules for determining whether a payment is treated as a deductible payment. However, the preamble to the proposed regulations states that, except as otherwise provided in the proposed regulations, the determination of whether a payment or accrual by the taxpayer to a foreign related party is

described in one of the four categories is made under general U.S. federal income tax law. REG–104259–18, 83 FR 65956, 65959 (December 21, 2018). The preamble to the proposed regulations refers specifically to agency principles, reimbursement doctrine, case law conduit principles, and assignment of income as examples of principles of generally applicable tax law. *Id.* A comment noted the potential for ambiguity that could result by failing to reflect in the text of the proposed regulations the language contained in the preamble to the proposed regulations and requested that the final regulations provide more specific guidance on how the determination of whether a payment is a base erosion payment is made. In response to this comment, the final regulations include in the regulatory text a rule that the determination of whether a payment or accrual is a base erosion payment is made under general U.S. federal income tax law. See § 1.59A–3(b)(2)(i).

Similarly, because existing tax law generally applies, the amounts of income and deduction for purposes of section 59A are generally determined on a gross basis under the Code and regulations. The proposed regulations generally do not permit netting of income and expense in determining amounts of base erosion payments. Comments to the proposed regulations requested guidance regarding (1) transactions involving a middle-man or a passthrough payment, (2) divisions of revenues in connection with global service arrangements, and (3) the general netting of income and expense.

#### 1. Transactions Involving a “Middle-Man” or “Passthrough Payments”

Several comments requested additional guidance relating to transactions or arrangements in which a taxpayer serves as a so-called middle-man for a payment to a foreign related party or makes a so-called passthrough payment to a foreign related party that may frequently arise in connection with global services and similar businesses. Broadly, the comments considered 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. Comments that addressed this concern arose in a variety of industries and business models. In some situations, the comments observed that business exigencies require the domestic corporation to make payments to the foreign related party. For example, in a business involving the physical delivery of goods within a foreign jurisdiction, a

domestic corporation may subcontract with its foreign related party to perform the foreign in-country delivery function. Another example involves global service contracts that may be entered into by a domestic corporation and a client that does business in multiple jurisdictions, and may require services in connection with the client’s global operations that are also subcontracted to foreign related parties. Some more specific comments observed that this global services situation may arise in connection with U.S.-based manufacturers that sell manufactured products to unrelated global customers and simultaneously enter into contracts to provide services for the product in multiple jurisdictions in connection with the sale of equipment. The comments observed that these service contracts, like other global services contracts, frequently involve subcontracting with a foreign related party to perform the services in foreign jurisdictions.

Multiple comments requested that the final regulations provide that the definition of a base erosion payment does not include payments made pursuant to a contract when a taxpayer makes a corresponding payment to a foreign related party for third party costs. Other comments requested that the final regulations more specifically exempt the types of business models discussed in the comment letters. For example, some comments recommended that the final regulations provide an exception to the term “base erosion payment” for payments made by a taxpayer to a foreign related party with respect to services performed for an unrelated party, provided that the foreign related party performs the services outside of the United States. Other comments recommended a similar exception that would apply only to services that are performed in connection with tangible property produced or manufactured by the taxpayer (or a related party). These comments observed that Congress intended to exclude manufacturers from the BEAT because it effectively created an exception for COGS, and that this exception should be carried through to services in connection with manufacturing.

Other comments recommended an exception to the definition of base erosion payment for payments to foreign related parties that are mandated under regulatory requirements. In other situations, comments observed that regulatory considerations affect the decision by the domestic corporation to make a payment to the foreign related party. An example includes a global dealing operation where a U.S.

securities dealer has a client who wants to trade its securities on a foreign securities exchange that requires a locally registered dealer; for those trades, a foreign related party of the U.S. securities dealer conducts those trades. Other examples involving regulatory considerations include U.S. life sciences companies that, in connection with obtaining food and drug approval to sell a product in a foreign market, use a foreign related party to conduct clinical trials in that market because foreign regulators require testing on local patients.

The final regulations do not adopt a general exception to the definition of a base erosion payment in situations when the foreign related payee also makes payments to unrelated persons. The BEAT statute and the legislative history contain no indication of such an exception. Moreover, this recommended exception is inconsistent with the statutory framework of the BEAT. If traced to the ultimate recipient, most expenses of a taxpayer could be linked to a payment to an unrelated party, through direct tracing or otherwise, leaving a residual of profit associated with the payment. Accordingly, adopting such an exception would have the effect of eliminating a significant portion of service payments to foreign related parties from the BEAT because it would impose the BEAT on the net rather than the gross amount of the payment. The only net income based concept included in the BEAT statute is the treatment of payments covered by the services cost method (“SCM”) exception. For a further discussion of the SCM exception, see Part IV.C.1 of this Summary of Comments and Explanation of Revisions.

The final regulations also do not adopt a narrower regulatory exception for payments that arise in similar circumstances but that are also associated with manufacturing or the production of tangible property. The Treasury Department and the IRS do not view the presence or absence of manufacturing as bearing on the statutory definition of a base erosion payment for services. Further, the Treasury Department and the IRS do not view the fact that payments that reduce gross receipts, such as COGS, are not base erosion payments under section 59A(d)(1) as demonstrating Congressional intent to exclude services that do not qualify as COGS from the definition of a base erosion payment under section 59A(d)(1) if those services have a connection to manufacturing operations. Congress included a single specific exception for services—the SCM exception. For a further discussion

of that exception, see Part IV.C.1 of this Summary of Comments and Explanation of Revisions.

The final regulations do not adopt a narrower exception for payments to foreign related parties that arise because of non-tax business considerations, including a non-tax foreign regulatory requirement. The Treasury Department and the IRS recognize that there may be non-tax reasons that compel a taxpayer to perform a particular global service outside the United States. For example, an international delivery service may need to engage a foreign related party in the destination country to deliver goods in a foreign jurisdiction.

The final regulations do not adopt this recommended exception because it would require rules to distinguish between the conditions under which a domestic corporation is compelled to operate through a foreign related party and the conditions under which a domestic corporation operates through a foreign related party as a result of a business choice. This distinction would be inherently subjective. For example, in a global service business that provides services to a global client that has operations around the world, the decision to provide personnel on-site in a foreign location may or may not be compelled by the business needs of its client. Similarly, in the case of the back-office functions of a global services business, those functions may be performed in the United States or in a location outside of the United States; the location of those services may or may not be compelled by the business needs of their client. Moreover, even if there is a compelling reason to operate the activities outside the United States, a base erosion payment exists only if a taxpayer makes a payment to a foreign related party. Thus, if a foreign branch of the domestic corporation performs services in the foreign jurisdiction, there will be no payment or accrual to a foreign related party. Finally, there is no indication that Congress intended to create a broad services exception, outside of the SCM exception, even though these global services conditions are common in the modern economy.

## 2. Division of Revenues From Global Services

Comments requested that final regulations provide an exception from the term “base erosion payment” for revenue sharing payments or arrangements, including allocations with respect to global dealing operations. Specifically, some comments recommended that the final regulations provide that a payment is not a base erosion payment in a

situation where the domestic corporation records revenue from transactions with third party customers, and in turn the domestic corporation makes payments to a foreign related party. Other comments recommended that payments by the domestic corporation to foreign related parties should not be base erosion payments if the parties have adopted a profit split as their best method of pricing the related-party transactions for purposes of section 482. Some of these comments asserted that parties to such payments could be viewed as splitting the customer revenue for purposes of section 59A. Under this view, the payments received by the foreign related party would be treated as received directly from the third-party customer, with the result that there would be no corresponding deductible payment from the domestic corporation to the foreign related party.

Other comments more specifically addressed this issue in the narrower context of a global dealing operation within the meaning of proposed § 1.482–8(a)(2)(i). These comments requested that payments made pursuant to a global dealing operation not be treated as base erosion payments.

The final regulations do not adopt the recommendations to specifically exclude from the definition of a base erosion payment transactions that are priced based on the profit split or similar transfer pricing method that is used for purposes of section 482. Under section 482, the parties to a controlled transaction apply the best method to determine if the parties are compensated at arm’s length. However, the use of a particular method, whether the profit split method or another method, does not change the contractual relationship between the parties. Accordingly, the final regulations do not adopt this recommendation because the proper characterization depends on the underlying facts and the relationships between the parties. See § 1.59A–3(b)(2).

Similarly, with respect to a global dealing operation, the final regulations do not adopt the comment to provide that global dealing operations do not give rise to base erosion payments because the proper characterization depends on the underlying facts. Under general tax principles, and consistent with proposed § 1.863–3(h), a global dealing operation in which participants manage a single book of assets, bear risk, and share in trading profits may be viewed as co-ownership of the trading positions or similar arrangement, with no deductible payments made by any participants for purposes of section 59A. In contrast, where non-U.S. participants

are compensated for services performed, the arrangement may be more properly characterized as trading income to the U.S. participant and a deductible payment to the foreign participant for purposes of section 59A.

To the extent that an amount is treated under general U.S. federal income tax law as received by a U.S. person as an agent for, and is remitted to, a foreign related party, see also Part IV.A (How Base Erosion Payments are Determined in General) of this Summary of Comments and Explanation of Revisions, which discusses the addition of § 1.59A–3(b)(2)(i) to clarify that the determination of whether a payment or accrual by the taxpayer to a foreign related party is described in one of four categories of a base erosion payment is made under general U.S. federal income tax law, including agency principles.

## 3. Netting of Income and Expense

Proposed § 1.59A–3(b)(ii) generally states that the amount of any base erosion payment is determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis, except as otherwise provided in paragraph (b)(2)(iii) of that section, which addresses mark-to-market positions, or as permitted by the Code or regulations. As explained in the preamble to the proposed regulations, the BEAT statutory framework is based on including the gross amount of base erosion payments in the BEAT’s expanded modified taxable income base. REG–104259–18, 83 FR 65956, 65968 (December 21, 2018).

### a. In General

Numerous comments recommended that the final regulations permit netting for purposes of section 59A. Generally, netting would allow a taxpayer to determine the amount of a base erosion payment by reducing the amount of that payment by the amount of another corresponding obligation.

A comment asserted that netting should be permitted for all base erosion payments other than with respect to reinsurance payments. The comment explained that the plain language of section 59A(d)(1) provides that only amounts paid or accrued are taken into account; this comment interpreted this language to mean the net amount paid or accrued. Because section 59A(d)(3) refers to gross premiums in the reinsurance context, the comment maintained that netting is permitted for other base erosion payments. This comment also noted that netting was provided under proposed section 4491, an inbound base erosion provision



included in section 4303 of the House version of H.R. 1, before the Senate amended H.R.1 to include the BEAT in place of proposed section 4491. This comment also recommended that netting be permitted because other sections of the Code or regulations include netting concepts, such as sections 163(j), 250 and 951A, and the aggregation rule in § 1.482–1T(f)(2)(i)(B).

Some comments recommended that the final regulations permit netting when the foreign related party payee has a corresponding obligation to make payments to an unrelated third party payee. Some of these comments asserted that base erosion payments arise because of commercial and regulatory efficiency and expediency, rather than because of tax planning. These comments recommended that netting be permitted in ordinary course transactions. Other comments recommended that the final regulations permit netting for deductible amounts owed by a domestic corporation to a foreign related party if the foreign related party also owes amounts to the domestic corporation and the obligations are settled on a net basis.

The Treasury Department and the IRS have determined that it is appropriate to retain the approach in the proposed regulations that the amount of a base erosion payment is determined on a gross basis, except as provided in the BEAT Netting Rule and to the extent permitted by the Code or regulations. See part III.D of this Summary of Comments and Explanation of Revisions (Mark-to-market deductions). As explained in the preamble to the proposed regulations, amounts of income and deduction are generally determined on a gross basis under the Code. REG–104259–18, 83 FR 65956, 65968 (December 21, 2018). For example, whether the amount of income or deductions with respect to financial contracts that provide for offsetting payments is taken into account on a gross or net basis is determined under generally applicable federal income tax law. Section 59A does not change that result.

The final regulations are consistent with the statutory framework of section 59A. Section 59A specifically addresses deductible payments and other statutorily defined base erosion payments, and imposes tax on an increased base of modified taxable income, but at a lower tax rate than the corporate income tax rate set forth in section 11. If regulations provided that statutorily defined base erosion payments could be reduced by offsetting amounts received, then the regulations would substantially limit the scope of

section 59A. Section 11 imposes a tax on a corporation's taxable income. Taxable income is defined as gross income minus the deductions allowed by chapter 1 of the Code. Section 63. Gross income is generally defined as income from whatever source derived. Section 61. The amount of income and deductions are generally determined on a gross basis under the Code. Nothing in section 59A evidences Congressional intent to alter this framework. In fact, section 59A(c) determines modified taxable income from the starting point of taxable income as defined in section 63.

A netting rule would have the same effect as allowing a deduction from gross income because it would reduce the amount of a taxpayer's modified taxable income, and in that sense would conflict with section 59A(c)(1) (disallowing a deduction for base erosion tax benefits). Congress determined that certain deductions, namely those that are within the statutory definition of a base erosion payment, should not be allowed for purposes of the tax imposed under section 59A, and therefore, limited the availability of these deductions. Permitting netting of items of gross income and deductions to determine the amount of a base erosion payment would frustrate Congress' purpose in enacting section 59A.

In addition, the other provisions of the Code and regulations that are cited by comments are irrelevant to the analysis of section 59A and do not provide support for adopting a netting rule for purposes of section 59A. Whereas sections 163(j) and 951A refer explicitly to net amounts, section 59A explicitly refers to a deduction allowable under Chapter 1 of the Code. Section 250 provides rules for determining whether services are for “foreign use” by contemplating services provided to and from a related party that are substantially similar. This destination-based rule is entirely different from the construct of section 59A, and, moreover, section 59A contains no similar language contemplating payments to and from a related party. Proposed section 4491 would have operated through the regular income tax system and would have represented a fundamentally different approach to inbound base erosion than section 59A; therefore, that proposed revision to the Code is not relevant here. The aggregation rule in § 1.482–1T(f)(2)(i)(B) does not involve the treatment of payments to foreign related parties, and thus is not relevant for purposes of analyzing the meaning of section 59A.

Some comments also cited the heading to section 59A(h) (exception for certain payments made in the ordinary course of trade or business) as support for a regulatory exception for ordinary course transactions for which a taxpayer has not adopted a mark-to-market method of accounting. Specifically, these comments suggested that Congress did not intend for section 59A(h)(2)(A)(i) to limit the QDP exception to only transactions that are marked-to-market. The citations to the heading to section 59A(h) are inconsistent with the statutory rule in section 59A(h), which provides a narrowly defined exception applicable to derivative payments under specific circumstances.

#### b. Hedging Transactions

Another comment recommended that the final regulations permit netting in the narrow context of related-party hedging transactions. The comment observed that the QDP exception applies to related-party hedging transactions when the taxpayer uses a mark-to-market method of accounting. The comment asserted that there is no policy rationale for limiting netting relief to taxpayers that use a mark-to-market method of accounting; therefore, the comment requested that the QDP exception be expanded to also apply to taxpayers that apply the mark-to-market method for financial accounting purposes. Alternatively, the comment recommended that taxpayers engaged in related-party hedging transactions be permitted to net income items against deduction items.

The final regulations do not provide for a netting rule for related-party hedging transactions. As discussed in Part IV.A.3.a of this Summary of Comments and Explanation of Revisions, permitting netting for related-party hedging transactions would be inconsistent with the statutory framework of section 59A. Furthermore, this recommendation would eliminate or substantially modify one of the three statutory requirements for the QDP exception (that is, use of the mark-to-market accounting method).

#### c. Clarification of Netting Under Current Law

Finally, some comments recommended that the final regulations clarify when netting is permitted under the Code and regulations, including confirming that netting is permitted for notional principal contracts and for cost sharing transaction payments under § 1.482–7(j)(3)(i). The Treasury Department and the IRS decline to provide such specific guidance because



it is beyond the scope of the final regulations; however, the Treasury Department and the IRS are cognizant that section 59A may place more significance on some sections of the Code than was the case before the Act. The Treasury Department and the IRS intend to study the effect of these provisions on the BEAT and whether changes should be made to the regulations thereunder to better take into account new considerations under the BEAT.

#### *B. Treatment of Certain Specific Types of Payments*

##### **1. Losses Recognized With Respect to the Sale or Transfer of Property to a Foreign Related Party**

Section 59A(d) defines a base erosion payment to include any amount paid or accrued by a taxpayer to a foreign related party with respect to which a deduction is allowable. Proposed § 1.59A-3(b)(1)(i) repeats this statutory language. Proposed § 1.59A-3(b)(2)(i) provides that “an amount paid or accrued” includes an amount paid or accrued using any form of consideration, including cash, property, stock, or the assumption of a liability. In explaining this provision, the preamble to the proposed regulations states that “a base erosion payment also includes a payment to a foreign related party resulting in a recognized loss; for example, a loss recognized on the transfer of property to a foreign related party.” REG-104259-18, 83 FR 65956, 65960 (December 21, 2018).

This principle would apply if, for example, a taxpayer transfers to a foreign related party (a) built-in-loss property as payment for a deductible service provided by the foreign related party to the taxpayer (the latter of which may also be a base erosion payment), (b) built-in-loss property as payment for a good or service that the taxpayer is required to capitalize (for example, COGS) such that the payment is not deductible to the taxpayer (the latter of which is not a base erosion payment), or (c) depreciated nonfunctional currency as a payment for a nonfunctional currency denominated amount owed by a taxpayer.

Comments requested that the final regulations revise the definition of a base erosion payment to exclude losses recognized on the sale or exchange of property by a taxpayer to a foreign related party. According to these comments, a payment made with, or a sale of, built-in-loss property is not encompassed within the statutory definition of a base erosion payment. Comments stated that both the statutory

and proposed regulations’ definition contain two requirements for a payment to be a base erosion payment: There must be (i) an amount paid or accrued by the taxpayer to a foreign person that is a related party of the taxpayer; and (ii) a deduction must be allowable with respect to that amount.

Regarding the first requirement—that there must be an amount paid or accrued by the taxpayer to a foreign related party—when a U.S. taxpayer sells property to a foreign related party for cash, the comments noted that no payment or accrual has taken place by the U.S. taxpayer for purposes of section 59A; rather, the U.S. taxpayer is receiving a cash payment in exchange for the transferred property, and is not making a payment. Thus, the comments argued, the first requirement for a base erosion payment, that a payment or accrual exists, has not been met.

Regarding the second requirement—that a deduction must be allowable with respect to that amount—comments argued that even if a payment is found to have been made to the foreign related party, the deduction for the loss on the built-in-loss property is not with respect to this payment. That is, the comments argued that the loss deduction is not attributable to any “payment” made to the foreign related party (the form of consideration in the transaction); rather, the loss is attributable to the taxpayer’s basis in the built-in loss property. Although that built-in-loss is recognized in connection with the transfer to a foreign related party, and thus could meet the statutory requirement as allowed “with respect to” the payment, the comments recommended a narrower interpretation that views the recognized loss as arising independently from the payment, that is viewed as merely a corollary consequence unrelated to the payment being made to the foreign related party.

The final regulations adopt the recommendation provided in these comments. The final regulations clarify the definition of a base erosion payment in § 1.59A-3(b)(1)(i) and (b)(2)(ix) to provide that a loss realized from the form of consideration provided to the foreign related party is not itself a base erosion payment. For the reasons described in the comments and discussed in this Part of the Summary of Comments and Explanation of Revisions, this treatment aligns the definition of base erosion payment with the economics of the payment made by the applicable taxpayer to the foreign related party. That is, 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. This rule applies regardless of whether the loss realized from the form of consideration provided to the foreign related party is itself consideration for an underlying base erosion payment. 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.

##### **2. Transfers of Property Between Related Taxpayers**

The proposed regulations limit the ability of a taxpayer to eliminate base erosion tax benefits by transferring depreciable or amortizable property to another member of the taxpayer’s aggregate group. Specifically, proposed § 1.59A-3(b)(2)(vii) provides that if a taxpayer holds depreciable or amortizable property that produces depreciation or amortization deductions that are base erosion tax benefits to the taxpayer, those depreciation or amortization deductions will continue to be treated as a base erosion tax benefit for the acquirer if the taxpayer transfers the property to another member of its aggregate group.

The Treasury Department and the IRS are aware of similar transactions involving a domestic corporation that ordinarily acquires, from a foreign related party, property that is subject to an allowance for depreciation or amortization in the hands of the domestic corporation. In the transaction, the domestic corporation inserts into its supply chain a second domestic corporation, with a principal purpose of avoiding base erosion payments. Specifically, the second domestic corporation, a dealer in property that avails itself of the exclusion of COGS from the definition of a base erosion payment in section 59A(d)(1) and (2), acquires the property from the foreign related party and in turn resells the property to the first domestic corporation. The Treasury Department and the IRS view this type of transaction as already within the scope of the anti-abuse rule set forth in proposed § 1.59A-9(b)(1) (transactions involving unrelated persons, conduits, or intermediaries), and have added an example to the final regulations clarifying the application of this anti-abuse rule to similar fact patterns.

##### **3. Corporate Transactions**

The proposed regulations provide that a payment or accrual by a taxpayer to a foreign related party may be a base erosion payment regardless of whether

the payment is in cash or in any form of non-cash consideration. *See* proposed § 1.59A–3(b)(2)(i). There may be situations where a taxpayer incurs a non-cash payment or accrual to a foreign related party in a transaction that meets one of the definitions of a base erosion payment, and that transaction may also qualify under certain nonrecognition provisions of the Code. Examples of these transactions include a domestic corporation's acquisition of depreciable assets from a foreign related party in an exchange described in section 351, a liquidation described in section 332, and a reorganization described in section 368.

The proposed regulations do not include any specific exceptions for these types of transactions even though (a) the transferor of the assets acquired by the domestic corporation may not recognize gain or loss, (b) the acquiring domestic corporation may take a carryover basis in the depreciable or amortizable assets, and (c) the importation of depreciable or amortizable assets into the United States in these transactions may increase the regular income tax base as compared to the non-importation of those assets. In the preamble to the proposed regulations, the Treasury Department and the IRS also note that for transactions in which a taxpayer that owns stock in a foreign related party receives depreciable property from the foreign related party as an in-kind distribution subject to section 301, there is no base erosion payment because there is no consideration provided by the taxpayer to the foreign related party in exchange for the property. REG–104259–18, 83 FR 65956, 65960 (December 21, 2018). Thus, there is no payment or accrual in that transaction.

The preamble to the proposed regulations requests comments about the treatment of payments or accruals that consist of non-cash consideration. REG–104259–18, 83 FR 65956, 65960 (December 21, 2018). Comments have suggested that corporate nonrecognition transactions or transactions in which U.S. taxpayers do not obtain a step-up in the tax basis of an acquired asset should not be treated as a base erosion payment. They argued that these nonrecognition transactions should not be treated as a payment or accrual. Based on this position, some comments argued either that the Treasury Department and the IRS do not have the authority to treat nonrecognition transactions as base erosion payments or that the better policy is to exclude nonrecognition transactions from the definition of base erosion payments. Furthermore, comments argued that

nonrecognition provisions such as sections 332, 351, and 368 reflect the judgment of Congress that certain corporate transactions such as the formation and dissolution of businesses and the readjustment of continuing interests in property do not warrant the imposition of tax. They also argued that the legislative history of section 59A does not suggest that Congress intended for it to apply to nonrecognition transactions.

With regard to section 332 liquidations, comments argued that a section 332 liquidation should not be treated as a base erosion payment when a section 301 distribution is not. Furthermore, comments argued that transactions in which stock is merely deemed to be exchanged, like certain section 351 transactions or section 332 liquidations, should not be treated as base erosion payments since there is no actual transfer of shares.

Comments also argued that nonrecognition transactions are not base eroding. Comments asserted that inbound nonrecognition transactions are often used in post-acquisition restructurings, as well as in other internal restructurings to better align a multinational organization's legal structure with its commercial operations. Comments also argued that treating these transactions as base erosion payments would provide a disincentive to move intangible property and other income-producing property into the United States, contrary to the goals of the Act.

Furthermore, comments argued that amortization of a carryover tax basis of an asset acquired by a U.S. taxpayer from a related party in a nonrecognition transaction would not create the same base erosion concerns as other types of deductions. However, comments acknowledged that, if final regulations adopted a broad exception for nonrecognition transactions, taxpayers could abuse that exception by engaging in certain basis step-up transactions immediately before an inbound nonrecognition transfer. Comments suggested that augmenting the conduit anti-abuse rule of proposed § 1.59A–9 may be sufficient to prevent these types of transactions. Alternatively, comments also suggested that, to delineate cases of potential abuse, a rule similar to the 5-year active trade or business rules in § 1.355–3 could apply to specify instances when assets would qualify as not being “recently stepped up assets.”

Comments generally supported the statement in the preamble to the proposed regulations that a section 301 distribution is not treated as a base erosion payment because there is no

exchange, and requested that the exclusion be included in the final regulations as well as the preamble. Comments also requested that the definition of a base erosion payment also exclude exchanges (including section 302 and 304 transactions) that are treated as section 301 distributions pursuant to section 302(d).

Comments have generally acknowledged that the taxable transfer of depreciable or amortizable property in exchange for stock should be subject to the BEAT. For example, comments stated that the transfer of assets to a corporation that is partially taxable to the transferor pursuant to section 351(b) or 356 as a result of the receipt of “boot” by the transferor is appropriately treated as a base erosion payment. The amount of the base erosion payment could be determined based on the gain or increase in basis of the property, the amount of boot allocated to the property, or by treating all of the boot as paid for depreciable or amortizable property first, to the extent thereof. Comments also requested clarity on the treatment of the assumption of liabilities pursuant to a nonrecognition transaction. One comment requested that the assumption of liabilities in a nonrecognition transaction be excluded from the definition of a base erosion payment to the extent that the assumption is not treated as money or other property. This comment suggested that, if the Treasury Department and the IRS are concerned about abusive transactions, an anti-abuse rule could be designed to treat certain liabilities as base erosion payments.

Similarly, comments stated that the taxable transfer of assets to a domestic corporation in exchange for stock, such as in a so-called “busted section 351 transaction,” should be subject to the BEAT. Comments also discussed whether a taxable distribution to a domestic corporation in a section 331 liquidation of a foreign corporation should be subject to the BEAT. These comments acknowledged that taxable transactions generally give rise to base erosion payments and did not take a view on whether section 331 liquidations should be subject to the BEAT. Accordingly, comments requested that nonrecognition transactions be excluded from the definition of a base erosion payment only to the extent that the U.S. taxpayer obtains a carryover basis in the acquired asset. Alternatively, comments have requested a safe harbor that would exclude nonrecognition transactions that are part of post-acquisition restructuring to allow taxpayers to transfer into the United States

intellectual property that was recently acquired from a third party. Comments have also requested that final regulations clarify that nonrecognition transactions that occurred before the effective date of the BEAT will not be treated as base erosion payments.

Finally, comments have noted that a nonrecognition transaction involving a U.S. branch of a foreign corporation may not qualify for the ECI exception under proposed § 1.59A-3(b)(3)(iii) for payments that are treated as effectively connected income in the hands of the payee, because the ECI exception under proposed § 1.59A-3(b)(3)(iii) is predicated on the payment or accrual being subject to U.S. federal income taxation, which cannot occur when the transaction is not taxable.

Consistent with these comments, the final regulations generally exclude amounts transferred to, or exchanged with, a foreign related party in a transaction described in sections 332, 351, and 368 (“corporate nonrecognition transaction”) from the definition of a base erosion payment. In light of the comments, the Treasury Department and the IRS have determined a limited exclusion of corporate nonrecognition transactions is consistent with the underlying anti-base erosion purpose of the BEAT, tends to reduce disincentives for taxpayers to move intangible property and other income-producing property into the United States in corporate nonrecognition treatment transactions, and is consistent with the general treatment of corporate nonrecognition transactions under other sections of the Code. However, the Treasury Department and the IRS have determined that it is not appropriate to apply this exception to the transfer of other property, or property transferred in exchange for other property, in a corporate nonrecognition transaction. Solely for purposes of determining what is a base erosion payment, “other property” has the meaning of other property or money, as used in sections 351(b), 356(a)(1)(B), and 361(b), as applicable, including liabilities described in section 357(b). However, other property does not include the sum of any money and the fair market value of any property to which section 361(b)(3) applies. Other property also includes liabilities that are assumed by the taxpayer in a corporate nonrecognition transaction, but only to the extent of the amount of gain recognized under section 357(c).

For example, if a foreign corporation transfers depreciable property to its wholly owned domestic subsidiary in a transaction to which section 351 applies, and if the foreign corporation

receives subsidiary common stock and cash in exchange, the cash may be treated as a base erosion payment, while the common stock is not. Similarly, property transferred in a section 351 or 368 transaction in exchange, in whole or in part, for other property may be a base erosion payment if it otherwise meets the definition of a base erosion payment. For example, if a domestic corporation transfers property to its wholly-owned foreign subsidiary in a transaction to which section 351 applies, and if the domestic corporation receives common stock in the foreign corporation and other property consisting of depreciable property, the property transferred by the domestic corporation may be a base erosion payment. These rules apply without regard to whether or not gain or loss is recognized in the transaction.

When a taxpayer transfers other property to a foreign related party, or transfers property to a foreign related party in exchange for other property, the determination of the amount of property that is treated as received from the foreign related party in exchange for the property transferred to the foreign related party is based on U.S. federal income tax law. See, for example, Rev. Rul. 68-55, 1968-1 C.B. 140.

Consistent with concerns raised by comments, the Treasury Department and the IRS are concerned that the exclusion of nonrecognition transactions could lead to inappropriate results in certain situations. An example of an inappropriate result is the sale of depreciable property between foreign related parties shortly before a nonrecognition transaction, which could step up the taxpayer's basis in the property and increase depreciation or amortization deductions of the domestic corporation after the nonrecognition transaction relative to the alternative in which the step-up basis transactions did not occur. Accordingly, the Treasury Department and the IRS have determined that it is appropriate to specifically address these transactions with an anti-abuse rule. See § 1.59A-9(b)(4). The anti-abuse rule applies in addition to, and in conjunction with, section 357(b). In addition, the Treasury Department and the IRS observe that, because the BEAT is applied after the application of general U.S. federal income tax law, other doctrines—including the step transaction doctrine and economic substance doctrine—also may apply.

Because the final regulations provide an exception for corporate nonrecognition transactions, it is not necessary for the final regulations to include other suggested modifications,

such as (i) modifying the ECI exception for nonrecognition transactions involving U.S. branches, (ii) providing a safe harbor that would exclude nonrecognition transactions that are part of a post-acquisition restructuring, or (iii) clarifying that nonrecognition transactions that occurred before the effective date of the BEAT are not treated as base erosion payments.

The final regulations also clarify the treatment of distribution transactions, such as distributions described in section 301, and redemption transactions, such as redemptions described in section 302. A distribution with respect to stock for which there is no consideration (a “pure distribution”) is not treated as an exchange. Accordingly, the final regulations provide that a pure distribution of property made by a corporation to a shareholder with respect to its stock is not an amount paid or accrued by the shareholder to the corporation. These pure distributions include distributions under section 301, without regard to the application of section 301(c) to the shareholder (addressing distributions in excess of earnings and profits). § 1.59A-3(b)(2)(ii). However, unlike a pure distribution, a redemption of stock in exchange for property constitutes an exchange. Accordingly, the final regulations provide that a redemption of stock by a corporation within the meaning of section 317(b) (such as a redemption described in section 302(a) and (d) or section 306(a)(2)), or an exchange of stock described in section 304 or section 331, is an amount paid or accrued by the shareholder to the corporation (or by the acquiring corporation to the transferor in a section 304 transaction).

#### 4. Interest Expense Allocable to a Foreign Corporation's Effectively Connected Income

##### a. In General

Section 59A applies to foreign corporations that have income that is subject to net income taxation as effectively connected with the conduct of a trade or business in the United States, taking into account any applicable income tax treaty of the United States. The proposed regulations generally provide that a foreign corporation that has interest expense allocable under section 882(c) to income that is effectively connected with the conduct of a trade or business within the United States will have a base erosion payment to the extent the interest expense results from a payment or accrual to a foreign related party. The amount of interest that will be treated as

a base erosion payment depends on the method used under § 1.882–5.

If a foreign corporation uses the three-step method described in § 1.882–5(b) through (d), the proposed regulations provide that interest on direct allocations and on U.S.-booked liabilities that is paid or accrued to a foreign related party will be a base erosion payment.<sup>1</sup> See proposed § 1.59A–3(b)(4)(i)(A). If U.S.-booked liabilities exceed U.S.-connected liabilities, the proposed regulations provide that a foreign corporation computing its interest expense under this method must apply the scaling ratio to all of its interest expense on a pro-rata basis to determine the amount that is a base erosion payment. The amount of interest on excess U.S.-connected liabilities that is a base erosion payment is equal to the interest on excess U.S.-connected liabilities multiplied by the foreign corporation's ratio of average foreign related-party liabilities over average total liabilities. See proposed § 1.59A–3(b)(4)(i)(A)(2).

If a foreign corporation determines its interest expense under the separate currency pools method described in § 1.882–5(e), the proposed regulations provide that the amount of interest expense that is a base erosion payment is equal to the sum of (1) the interest expense on direct allocations paid or accrued to a foreign related party and (2) the interest expense in each currency pool multiplied by the ratio of average foreign related-party liabilities over average total liabilities for that pool. See proposed § 1.59A–3(b)(4)(i)(B).

Comments requested that a consistent method apply to determine the portion of interest allocated to a U.S. branch that is treated as paid to a foreign related party. The comments noted that the methods in the proposed regulations may produce meaningfully different amounts of base erosion payments depending on which method the taxpayer uses to determine its branch interest expense. Comments noted that a branch that uses the method described in § 1.882–5(b) through (d) may have a lower amount of base erosion payments than a branch using the method described in § 1.882–5(e) or a permanent establishment applying a U.S. tax treaty, although those differences will ultimately depend on the composition of the counterparties of the U.S.-booked

liabilities and the excess U.S.-connected liabilities (as foreign related parties or not foreign related parties). See also Part IV.B.5 of this Summary of Comments and Explanation of Revisions for a discussion of interest allowed to permanent establishments applying a U.S. tax treaty. The comments argued that these differences are not supported by tax policy.

Comments generally requested a rule permitting or requiring foreign corporations to use U.S.-booked liabilities to determine the portion of U.S. branch interest expense that is treated as paid to foreign related parties, consistent with the method described in the proposed regulations for corporations that determine U.S. branch interest expense using the method described in § 1.882–5(b) through (d), even if the U.S. branch uses a different method to determine its interest expense. The comments argued that U.S. assets are used to determine the amount of leverage that is properly allocable to a U.S. branch, and, as a result, U.S.-booked liabilities should determine the amount of interest treated as a base erosion payment. Specifically with regard to banks, a comment argued that banks are highly regulated with limited or no ability to manipulate U.S.-booked liabilities, and, as a result, should be permitted to use U.S.-booked liabilities to determine the amount of U.S. branch interest expense treated as paid to foreign related parties.

The Treasury Department and the IRS agree that the rules for determining the portion of U.S. branch interest paid to foreign related parties should be consistent, regardless of whether taxpayers apply the method described in § 1.882–5(b) through (d) or § 1.882–5(e). For purposes of section 59A, the Treasury Department and the IRS agree that the starting point for determining the identity of the recipient should be the U.S. booked liabilities of the U.S. branch. The final regulations, therefore, provide that the amount of U.S. branch interest expense treated as paid to a foreign related party is the sum of: (1) The directly allocated interest expense that is paid or accrued to a foreign related party, (2) the interest expense on U.S.-booked liabilities that is paid or accrued to a foreign related party, and (3) the interest expense on U.S.-connected liabilities in excess of interest expense on U.S.-booked liabilities multiplied by the ratio of average foreign related-party interest over average total interest (excluding from this ratio interest expense on U.S. booked liabilities and interest expense directly allocated). See § 1.59A–3(b)(4)(i)(A); see also Part IV.B.4.b.i of

this Summary of Comments and Explanation of Revisions (discussing the change from a worldwide liability ratio to a worldwide interest ratio). In adopting a consistent approach, the final regulations use the same ratio to determine whether the interest expense on U.S.-connected liabilities is paid to a foreign related party regardless of whether a taxpayer applies the method described in § 1.882–5(b) through (d) or § 1.882–5(e). See § 1.59A–3(b)(4)(i)(A)(3).

#### b. Simplifying Conventions

The Treasury Department and the IRS recognize that § 1.882–5 provides certain simplifying elections for determining the interest deduction of a foreign corporation. The proposed regulations request comments about similar simplifying elections for determining the portion of U.S.-connected liabilities that are paid to a foreign related party for purposes of section 59A. REG–104259–18, 83 FR 65956, 65960 (December 21, 2018).

Comments, in response to the request for comments on simplifying conventions, indicated that it may be difficult for foreign corporations to determine their worldwide ratio of liabilities owed to foreign related parties over total liabilities (“worldwide liabilities ratio”). For example, they argued that U.S. branches of foreign banks typically do not have full access to information about the bank's global operations and funding arrangements. These comments argued that even if a U.S. branch does have that information, U.S. tax law may treat some transactions as debt that non-U.S. tax law does not, or may integrate some hedging costs that are not integrated for non-U.S. tax purposes, or vice-versa. These comments further observed that if the taxpayer is using the fixed ratio election for purposes of § 1.882–5, the taxpayer would not be required to obtain that information or reconcile the home office balance sheet to U.S. tax law principles for purposes of § 1.882–5. Thus, the comments argued that attempting to reconstruct a global balance sheet and payments under U.S. tax principles for purposes of proposed § 1.59A–3 is burdensome and should not be required.

The comments also requested various simplifying elections for determining the amount of U.S. branch interest treated as paid to foreign related parties, including (a) computing the worldwide ratio by reference to interest expense rather than worldwide liabilities (“worldwide interest ratio”), (b) using financial accounting books and records rather than U.S. tax principles to determine a worldwide ratio, or (c)

<sup>1</sup> For purposes of § 1.882–5, direct allocations generally refer to the requirement that a foreign corporation allocate interest expense to income from particular assets; these circumstances generally arise with respect to (i) certain assets that are subject to qualified nonrecourse indebtedness or (ii) certain assets that are acquired in an integrated financial transaction.

providing a fixed ratio for purposes of determining the minimum amount of interest treated as paid to third parties (such as 85 percent).

#### i. Worldwide Interest Ratio

The final regulations adopt the comment recommending that taxpayers apply the worldwide ratio to determine the amount of a U.S. branch's interest expense paid to foreign related parties by reference to a worldwide ratio of interest expense, rather than a worldwide ratio of liabilities. *See* § 1.59A-3(b)(4)(i)(A)(3). The final regulations adopt this approach as a rule, rather than as an election, because the Treasury Department and the IRS agree with the comments that a worldwide ratio based on interest expense, rather than liabilities, is the appropriate measurement for determining a U.S. branch's base erosion payments. Section 59A determines the amount of interest that is a base erosion payment based on the amount of interest paid or accrued to foreign related parties, rather than the amount of liabilities owed to foreign related parties. Accordingly, the final regulations determine the amount of a U.S. branch's interest expense treated as a base erosion payment based on the foreign corporation's worldwide interest ratio.

#### ii. Use of Applicable Financial Statements

The Treasury Department and the IRS recognize that it may be difficult for foreign corporations to determine their worldwide interest ratio under U.S. tax principles, as indicated by the comments. Accordingly, for simplicity and to reduce the administrative burden on taxpayers, the final regulations adopt the comment to allow taxpayers to elect to determine their worldwide interest ratio using their applicable financial statements as described in section 451(b)(3). *See* § 1.59A-3(b)(4)(i)(D). The final regulations also clarify that the applicable financial statement must be the applicable financial statement of the taxpayer, not a consolidated applicable financial statement, because a consolidated applicable financial statement may eliminate inter-company liabilities. The final regulations provide that a taxpayer makes this election on Form 8991 or a successor form. Until the Form 8991 is revised to incorporate the election, a taxpayer should attach a statement with that form to make this election as provided in forms and instructions.

#### iii. Fixed Ratio or Safe Harbor for the Worldwide Interest Ratio

The final regulations do not adopt a fixed ratio or safe harbor for the worldwide interest ratio as suggested in comments because the actual worldwide interest ratio of an enterprise may vary significantly from one industry to another and from one taxpayer to another. As a result, it is not possible to establish a single safe harbor that appropriately takes into account the differing position of industries and taxpayers while protecting the interests of the government. The Treasury Department and the IRS recognize that § 1.882-5 provides other safe harbors, such as the fixed ratio safe harbor for determining the ratio of liabilities to assets of 95 percent for banks and 50 percent for other taxpayers. § 1.882-5(c)(4). In the context of determining the portion of a U.S. branch's interest expense that is deemed attributed to foreign related parties (versus other persons), the Treasury Department and the IRS determined that there is not a sufficient basis to establish a safe harbor because different taxpayers could have different internal capital structures.

One comment suggested that a U.S. branch of a bank should be permitted to assume that 85 percent of its funding is from unrelated lenders because regulations under section 884 provide a safe harbor assumption that 85 percent of a bank's capital can be deemed to come from deposits (and thus eligible for the bank deposit interest exemption from the tax imposed by section 881(a)). *See* § 1.884-4(a)(2)(iii). The section 884 safe harbor, however, is not relevant to the determination of the ratio of funding from foreign related parties because the bank deposit exception is available for both related and unrelated depositors/lenders. Thus, this section 884 safe harbor does not reflect the expected percentage of the lenders who are not foreign related parties. *See* section 871(i)(2) and section 881(d).

#### c. Other Coordinating Rules

The final regulations also revise § 1.59A-3(b)(4)(1) to take into account the expansion of the exception for certain total loss-absorbing capacity securities to include foreign issuers. *See* Part IV.C.5 of this Summary of Comments and Explanation of Revisions (Exception for Interest on Certain Instruments Issued by Globally Systemically Important Banking Organizations).

Finally, a comment recommended that the final regulations revise proposed § 1.59A-3(b)(4)(i)(D), which provides that to the extent that a

taxpayer makes an election to reduce its U.S.-connected liabilities pursuant to § 1.884-1(e)(3), the reduction is treated as proportionally reducing all liabilities for purposes of determining the amount of allocable interest expense that is treated as a base erosion payment. The comment argued that § 1.59A-3(b)(4)(i)(D) is inconsistent with § 1.884-1(e)(3), which applies for all purposes of the Code, and which the comment asserted does not require proportionate reduction. In response to this comment, the final regulations do not include the rule in proposed § 1.59A-3(b)(4)(i)(D). The Treasury Department and the IRS are considering § 1.884-1(e)(3) for possible future guidance.

#### 5. Allocations of Interest and Other Expenses Pursuant to Income Tax Treaties

The proposed regulations provide a specific rule for determining the amount of base erosion payments attributable to interest and deductions allocated to a permanent establishment under a U.S. income tax treaty. Certain U.S. income tax treaties provide alternative approaches for the allocation or attribution of business profits of an enterprise of one contracting state to its permanent establishment in the other contracting state on the basis of assets used, risks assumed, and functions performed by the permanent establishment. These treaties allow notional payments that take into account interbranch transactions and value the interbranch transactions using the most appropriate arm's length method for those transactions. A treaty-based expense allocation or attribution method does not itself create legal obligations between the U.S. permanent establishment and the rest of the enterprise. The proposed regulations reflect that under a treaty-based expense allocation or attribution method, amounts equivalent to deductible payments may be allowed in computing the business profits of an enterprise with respect to transactions between the permanent establishment and the home office or other branches of the foreign corporation ("internal dealings"). The deductions from internal dealings would not be allowed under the Code and regulations. The proposed regulations provide that deductions from internal dealings allowed in computing the business profits of the permanent establishment are base erosion payments.

The proposed regulations distinguish between the allocations of expenses and internal dealings. The allocation and apportionment of expenses of the

enterprise to the branch or permanent establishment is not a base erosion payment because the allocation represents a division of the expenses of the enterprise, rather than a payment between the branch or permanent establishment and the rest of the enterprise. Internal dealings, however, are not mere divisions of enterprise expenses; rather, internal dealings are priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle. The proposed regulations create parity between deductions for actual regarded payments between two separate corporations (which are subject to section 482), and internal dealings (which are generally priced in a manner consistent with the applicable treaty and, if applicable, the OECD Transfer Pricing Guidelines). The proposed regulations apply only to deductions attributable to internal dealings, and not to payments to entities outside of the enterprise, which are subject to the general base erosion payment rules as provided in proposed § 1.59A–3(b)(4)(v)(A).

Comments noted that internal dealings are a fiction and do not involve an actual payment or accrual under general U.S. tax principles. The comments suggested that internal dealings should be relevant only for purposes of determining the profit attributable to the permanent establishment and should not be recognized for other purposes. They noted that the OECD 2010 Report on the Attribution to Profits to Permanent Establishments (“2010 OECD Report”) states that recognizing internal dealings by a permanent establishment “is relevant only for the attribution of profits” and “does not carry wider implications as regards, for example, withholding taxes.” 2010 OECD Report (July 22, 2010), Part IV, C–1(iii)(f), section 166. Thus, comments suggested that internal dealings should not be relevant for BEAT purposes.

The Treasury Department and the IRS disagree that internal dealings are not relevant for purposes of determining a foreign corporation's base erosion payments. Unlike the allocation of a foreign corporation's deductions to a U.S. branch under the Code and regulations, internal dealings are not a mere allocation of expenses, but rather are determined on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle. Deductions determined under internal dealings, like deductions determined

under the Code and regulations, reduce the U.S. income tax base of the permanent establishment. Because internal dealings are not an allocation of expenses, the foreign corporation's worldwide ratio may not be an appropriate measure of related party payments. Instead, in the proposed regulations, the Treasury Department and the IRS determined that it is appropriate to look to the internal dealings, rather than the foreign corporation's worldwide expenses, for purposes of determining base erosion payments.

However, the Treasury Department and the IRS recognize that interest expense allowed to a permanent establishment as internal dealings often represents interest expense on back-to-back loans between (1) the permanent establishment and the home office, and (2) the home office and another entity. Furthermore, unlike other deductions that are often based on payments to the home office or to another branch for goods or services or the use of intellectual property unique to the home office or branch, money is fungible. A permanent establishment may be indifferent to whether its capital comes from the home office or a loan from another entity.

The Treasury Department and the IRS have determined that interest expense determined under § 1.882–5 generally provides a reasonable estimate of the amount of interest of the foreign corporation that should be allocated to the permanent establishment based on the assets of the permanent establishment. Accordingly, it is appropriate to treat interest expense determined in accordance with a U.S. tax treaty (including interest expense determined by internal dealings) in a manner consistent with the treatment of interest expense determined under § 1.882–5, to the extent it would have been allocated to the permanent establishment under § 1.882–5. In effect, the internal dealing permits the permanent establishment to replace an external borrowing with an internal dealing, and this internal dealing should be treated as creating additional interest expense paid to the home office, and thus treated as a base erosion payment to a foreign payee. Accordingly, interest expense determined in accordance with a U.S. tax treaty (including interest expense determined by internal dealings) that is in excess of the amount that would have been allocated to the permanent establishment under § 1.882–5 is treated as interest expense paid by the permanent establishment to the home office or another branch of the foreign corporation.

Specifically, the final regulations treat interest expense determined in accordance with a U.S. tax treaty (including interest expense determined by internal dealings) in a manner consistent with the treatment of interest expense determined under § 1.882–5, to the extent of the hypothetical amount of interest expense that would have been allocated to the permanent establishment under § 1.882–5 (the “hypothetical § 1.882–5 interest expense”). For purposes of this calculation, the hypothetical § 1.882–5 interest expense cannot exceed the amount of interest expense determined under the U.S. tax treaty. Interest expense in excess of the hypothetical § 1.882–5 interest expense is treated as interest expense paid by the permanent establishment to the home office or another branch of the foreign corporation, and therefore is treated as a base erosion payment. *See* § 1.59A–3(b)(4)(i)(E).

Accordingly, under the final regulations, a foreign corporation determines its hypothetical § 1.882–5 interest expense by calculating the amount of interest that would have been allocated to effectively connected income if the foreign corporation determined its interest expense under § 1.882–5. *See* § 1.59A–3(b)(4)(i)(E)(2). Therefore, a foreign corporation will use the method provided in § 1.59A–3(b)(4)(i)(A), as described in Part IV.B.4.a in this Summary of Comments and Explanation of Provisions, to determine its hypothetical § 1.882–5 interest expense.

In this regard, the Treasury Department and the IRS observe that corporations eligible for benefits under a U.S. income tax treaty are permitted to choose whether to apply the treaty or the Code and regulations to calculate interest expense allocable to a permanent establishment or U.S. branch, and understand that many corporations eligible for treaty benefits calculate interest expense allocated to a U.S. branch or permanent establishment under both § 1.882–5 and the applicable treaty to determine whether to claim treaty benefits. Additionally, the Treasury Department and the IRS also understand that corporations that determine interest expense allowed to a permanent establishment under a U.S. income tax treaty may nonetheless be required to allocate interest to the permanent establishment under § 1.882–5 for state or local tax purposes.

#### 6. Related-Party Hedging Payments

Comments requested that the final regulations provide relief from the application of the BEAT for hedging

payments made by domestic corporations to foreign related parties, specifically in the context of the energy industry. The comments described a scenario in the energy industry where large multinational groups designate one or more members of their worldwide group to act as a hedging center to manage price risk associated with commodities that the group produces or sells through the execution of commodities derivatives. The comments indicated that under prevailing industry practice and applicable financial accounting standards, income, gain, loss, or expense on commodity derivatives are often accounted for as items of COGS or as a reduction to determine gross income for book accounting purposes. These items, however, are not treated as COGS or as another form of reduction to determine gross income for tax purposes; the items are deductions for tax purposes and potentially within the scope of section 59A(d)(1) and proposed § 1.59A–3(b)(1)(i). The payments described in these comments are not eligible for the QDP exception in section 59A(h) and proposed § 1.59A–6. The comments requested that the final regulations include a rule that related-party hedging payments are not base erosion payments.

The final regulations do not adopt this recommendation. The status of an item as a deduction is determined under U.S. federal income tax law, not industry practice or financial accounting treatment. Although the legislative history of section 59A states that base erosion payments do not include any amount that constitutes reductions to determine gross income, including payments for COGS, these statements are in the context of U.S. federal income tax law, which sets forth the tax law for deductions. In addition, section 59A(d)(1) refers to “deductions allowable under this chapter,” that is, chapter 1 (normal taxes and surtaxes) of Subtitle A (income taxes) of the Code, which includes section 1 through section 1440Z–2. Congress did not indicate that the definition of a reduction to determine gross income or COGS for purposes of section 59A should be derived from financial accounting principles. In the absence of clear Congressional intent otherwise, the Treasury Department and the IRS believe that whether an amount constitutes a reduction to determine gross income or COGS must be determined under established principles of U.S. federal income tax law. Consequently, if related-party hedging payments are not properly treated as

reductions to determine gross income for tax purposes, these payments are not excluded from the definition of base erosion payments. See also Part IV.A.3.b of this Summary of Comments and Explanation of Revisions (Netting of income and expense; Hedging transactions).

#### 7. Captive Finance Subsidiaries

Comments addressed the impact of the BEAT on domestic corporate captive finance subsidiaries that purchase property (business equipment) from a foreign related party and then lease the property to unrelated third party end users. The comments requested that the final regulations permit taxpayers using this type of business model to treat the depreciation deductions attributable to the leased property as COGS for purposes of the BEAT. The comments premised this requested treatment on the theory that the cost of the leased property and its associated depreciation deductions are directly correlated with the rental income generated from leasing the property and on the unique nature of this particular business model.

The final regulations do not include an exception from the definition of base erosion payments for the transactions described in these comments. Under section 59A(d)(2), the deduction allowed for depreciation with respect to property acquired from a foreign related party is a base erosion tax benefit, notwithstanding that the property acquired by the taxpayer is used in an income-generating business in the United States, such as the leasing of the business equipment to unrelated third party lessees of the property or operating the business equipment itself as a service for unrelated third parties.

#### 8. Capitalization and Amortization of Research and Experimental Expenditures

One comment recommended that the final regulations clarify the treatment of research and experimental (“R&E”) expenditures after such costs are required to be amortized in taxable years beginning after December 31, 2021, under section 174. The comment recommended clarification that after the change to section 174 is in effect, the BEAT payment associated with R&E expenses is limited to the amount of amortization. The final regulations do not adopt this comment because the Treasury Department and the IRS view § 1.59A–3(b)(1)(i) and § 1.59A–3(c)(1)(i) as sufficiently clear in setting forth that a base erosion payment to a foreign related party does not result in a base erosion tax benefit until the deduction

is “allowed under chapter 1 of subtitle A of the [Code].”

#### C. Other Exceptions From the Base Erosion Payment Definition Contained in the Proposed Regulations

##### 1. Exception for Certain Amounts With Respect to Services and the Services Cost Method

Proposed § 1.59A–3(b)(3)(i) provides that a base erosion payment does not result from amounts paid or accrued to a foreign related party for services that are eligible for the SCM exception described in proposed § 1.59A–3(b)(3)(i)(B), but only to the extent of the total services cost of those services. Any amount paid or accrued to a foreign related party in excess of the total services cost of services eligible for the SCM exception (the mark-up component) remains a base erosion payment. Proposed § 1.59A–3(b)(3)(i)(B) provides that the SCM exception applies if all of the requirements of § 1.482–9(b), which describes the SCM, are satisfied, with two exceptions. First, the requirements of § 1.482–9(b)(5), commonly referred to as the business judgment rule, do not apply. Second, the books and records requirement described in § 1.482–9(b)(6) is replaced with the requirements of proposed § 1.59A–3(b)(3)(i)(C). Section 1.482–9(b)(4) provides that certain activities, including research, development, and experimentation, are not eligible for the SCM. As a result, payments for these services do not qualify for the SCM exception described in proposed § 1.59A–3(b)(3)(i)(B).

Comments supported the SCM exception and recommended that final regulations adopt this approach. The final regulations continue to provide that the SCM exception is available for the cost portion of a payment that otherwise meets the requirements for the SCM exception. A comment recommended that the final regulations provide examples or clarification as to the requirement in proposed § 1.59A–3(b)(3)(i)(C) that taxpayers’ books and records provide sufficient documentation to allow verification of the methods used to allocate and apportion the costs to the services in question in accordance with § 1.482–9(k). The final regulations include additional detail on the documentation required to satisfy this requirement. § 1.59A–3(b)(3)(i)(C).

Comments also recommended that the final regulations extend the SCM exception to the cost element of payments for other types of services that are not eligible for the SCM. Some comments suggested that an exception



should be available for all services. Some comments suggested that an exception should be available for services that are excluded under § 1.482–9(b)(4) (excluded activities) but that otherwise would be eligible for the SCM exception described in proposed § 1.59A–3(b)(3)(i)(B). Some comments suggested that an exception should be available for research and experimentation services.

Comments suggested that applying the SCM exception to only some services will lead to inequitable results for services companies as compared to similarly situated U.S. manufacturers and distributors because the definition of base erosion payments does not include payments included in COGS, but there is not a similar rule for the costs in a services business. Comments also claimed that, relative to manufacturers or distributors, service companies are more constrained in where they operate. Comments also asserted that no base erosion could result from an expansion of the SCM exception because only the cost element of the service fee would be subject to the exception.

The comments suggesting that an exception should be available for excluded activities that otherwise would be eligible for the SCM also asserted that the list of excluded activities serves a similar purpose as the business judgment rule, which is to identify services for which total services costs can constitute an inappropriate reference point for determining profitability or that should be subject to a more robust transfer pricing analysis. Comments suggested that § 1.482–9(b)(4) is essentially a list of specific activities for which the SCM is unavailable because they are deemed to contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure of the business. These comments suggested that when section 59A(d) states that the exception therein is based on compliance with the services cost exception in section 482 “(determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)”, that language was intended to disregard the list of excluded activities.

The comments requesting an expansion of the SCM exception for research and experimentation services also asserted that extending the SCM exception to these services would reduce the incentive to move intangible property offshore and would broaden the U.S. tax base by encouraging U.S.

ownership and exploitation of newly created intangible property.

Section 59A(d)(5)(A) sets forth the parameters under which certain services—those that are eligible for the SCM without regard to the business judgment rule—are eligible for the SCM exception. The Treasury Department and IRS have considered the policy considerations that the comments raised for expanding the SCM exception, but have determined that the recommendation to expand the SCM exception is inconsistent with the parameters that Congress set forth in section 59A(d)(5). Further, the Treasury Department and IRS disagree with the premise in the comments that the list of excluded activities serves the same purpose as the business judgment rule. While certain services that are ineligible for the SCM as a result of being on the list of excluded activities also may be ineligible for the SCM as a result of failing the business judgment rule, the list of excluded activities from the SCM provides an objective list of categories that tend to be high margin or for which the cost of the services tends to be an inappropriate reference point for the price of those services. *See* 71 FR 44466, 44467–68 (Aug. 4, 2006). By contrast, the business judgment rule also excludes from the SCM services that tend to be low margin as a general matter, but in the context of a particular business are a core competency of the business. *See* 71 FR 44466, 44467 (Aug. 4, 2006). The parenthetical language in section 59A(d)(5)(A) indicates unambiguously that Congress intended the SCM exception to be available for all services that are typically low margin even if, in the context of a particular business, the service is a core competency of a business that may not satisfy the criteria in § 1.482–9(b)(5). Accordingly, the Treasury Department and the IRS have determined that the SCM exception should continue to follow the statute, and the rule is unchanged from the proposed regulations.

## 2. Qualified Derivatives Payments

For a discussion of QDPs, see Part VII of this Summary of Comments and Explanation of Revisions.

## 3. Exception to Base Erosion Payment Status for Payments the Recipient of Which Is Subject to U.S. Tax

Proposed § 1.59A–3(b)(3)(iii) generally provides that a base erosion payment does not result from 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 (ECI). Comments recommended that final regulations adopt this rule. Accordingly, this rule is unchanged in the final regulations.

Several comments recommended that final regulations include a similar exception from the definition of a base erosion payment for payments made by a domestic corporation to a controlled foreign corporation (CFC) that result in a subpart F or global intangible low tax income (GILTI) inclusion. Another comment requested that this exception be extended to apply to payments made to a passive foreign investment company (PFIC) when a U.S. person has made a qualified electing fund (QEF) election, and the payment is included in the electing U.S. person's gross income. The comments asserted that payments that give rise to a subpart F or GILTI inclusion do not erode the U.S. tax base, and accordingly, warrant a base erosion payment exception under the same policy rationale for granting this type of exception in the proposed regulations for ECI, section 988 losses, and interest paid with respect to total loss-absorbing capacity (TLAC) securities. Finally, comments noted that proposed regulations under section 267A provide an exception for certain payments that result in income inclusions under section 951 and section 951A and suggested equivalent treatment was justified in the case of the BEAT.

The final regulations do not include a subpart F, GILTI, or PFIC exception to base erosion payment status. The Treasury Department and the IRS have determined that the reasons for adopting the other exceptions cited in the comments (such as the ECI exception and the exception under section 267A) do not warrant a subpart F, GILTI, or QEF exception from base erosion payment status.

First, comments have misinterpreted the underlying policy rationale for providing an ECI exception in the proposed regulations. The proposed regulations' ECI exception was adopted in part based upon the determination that it would be appropriate in defining a base erosion payment to consider the U.S. federal tax treatment of the foreign recipient—particularly, whether a payment received by a foreign related party was subject to tax on a net basis in substantially the same manner as amounts paid to a U.S. person. In contrast to the tax directly imposed on a foreign person with respect to its ECI under sections 871(b) and 882(a), a CFC receiving a base erosion payment is not directly subject to U.S. taxation. Rather, the U.S. shareholder is subject to tax under the subpart F or GILTI regime (or the PFIC rules). Thus, the CFC recipient

(or PFIC recipient) of a payment is not itself subject to tax on a net basis in substantially the same manner as a U.S. person.

In addition, a foreign corporation that is engaged in a U.S. trade or business is itself subject to section 59A. In contrast, because neither a CFC nor a PFIC is subject to section 59A, the CFC or PFIC can make payments to a foreign related party without any BEAT consequences.

The ECI exception was also adopted to achieve symmetry with proposed § 1.59A–2(c), which treats foreign corporations as outside of the controlled group, except to the extent that the foreign corporation has ECI. Because foreign corporations with ECI are treated as part of the aggregate group in determining whether a taxpayer will ultimately be subject to the BEAT, the ECI exception to base erosion payment status is necessary to ensure that the foreign corporation is treated equivalently to a domestic member of its aggregate group receiving deductible payments.

The Treasury Department and the IRS further disagree with the premise that the approaches in the proposed regulations with respect to TLAC interest and section 988 losses support an exception for subpart F or GILTI income in the final regulations. With respect to TLAC, the preamble to the proposed regulations notes that the TLAC exception is appropriate because of the special status of TLAC as part of a global system to address bank solvency and the precise limits that regulations place on the terms of TLAC securities. REG–104259–18, 83 FR 65956, 65963 (December 21, 2018).

With respect to section 988, the preamble to the proposed regulations states that the exception is based on a determination that the losses did not present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party. *See* REG–104259–18, 83 FR 65956, 65963 (December 21, 2018).

The Treasury Department and the IRS also disagree with the premise that the approach in the proposed hybrid regulations under section 267A provides support for a regulatory exception. Section 267A(b)(1) expressly provides that the disqualified related-party amount does not include any payment to the extent that the payment is included in the gross income of a United States shareholder under section 951(a). Whereas Congress expressly provided an exception for subpart F in section 267A, Congress did not provide a similar exception for purposes of section 59A. The Treasury Department and the IRS have determined that the

inclusion of a similar exception in another section of the Act, but not in section 59A, reflects Congressional intent to not provide a GILTI or subpart F exception for purposes of section 59A. In addition, section 59A(c)(4)(B) provides that a deduction under section 250 (providing a domestic corporation a deduction for a portion of its GILTI amount) is not included in the denominator for purposes of the base erosion percentage; this shows that Congress considered the interaction between section 59A and GILTI, but did not provide an exception from the term base erosion payment for payments subject to tax under section 951A.

Finally, with respect to the suggested GILTI exception, the Treasury Department and the IRS are concerned that a GILTI exception would be difficult to administer because it would require a determination of whether a particular payment to a CFC is included in the taxpayer's GILTI inclusion, but a taxpayer's GILTI inclusion often cannot be traced to particular payments to a CFC because a taxpayer's GILTI inclusion amount depends on multiple factors. A GILTI exception would also need to take into account differences in effective and marginal tax rates under GILTI, BEAT, and regular corporate income tax.

For the foregoing reasons, the final regulations do not provide a regulatory exception to the definition of a base erosion payment for a payment that may give rise to subpart F, GILTI, or PFIC inclusions.

#### 4. Exchange Loss From a Section 988 Transaction

Proposed § 1.59A–3(b)(3)(iv) provides that exchange losses from section 988 transactions described in § 1.988–1(a)(1) are excluded from the definition of base erosion payments. Proposed § 1.59A–2(e)(3)(ii)(D) provides that an exchange loss from a section 988 transaction (including with respect to transactions with persons other than foreign related parties) is not included in the denominator when calculating the base erosion percentage. The preamble to the proposed regulations requests comments on whether the denominator should exclude only section 988 losses with respect to foreign related-party transactions. REG–104259–18, 83 FR 65956, 65963 (December 21, 2018). Comments recommended that section 988 losses should not be excluded from the denominator of the base erosion percentage because excluding all section 988 losses is not consistent with the statute. Some comments, however, recommended that section 988 losses with respect to transactions with foreign

related parties that are also excluded from the numerator should continue to be excluded from the denominator, and that this approach would be symmetrical with the approach in the statute for deductions for qualified derivative payments and for amounts eligible for the SCM exception. The final regulations adopt this recommendation. *See* § 1.59A–2(e)(3)(ii)(D). This approach is also consistent with the treatment of amounts paid to foreign related parties with respect to TLAC securities, which are excluded from the denominator only if the deductions arise from foreign related-party transactions.

#### 5. Exception for Interest on Certain Instruments Issued by Globally Systemically Important Banking Organizations (GSIBs)

Proposed § 1.59A–3(b)(3)(v) provides that the amount paid or accrued to a foreign related party with respect to total loss-absorbing capacity (“TLAC”) securities is not a base erosion payment, but only to the extent of the amount of TLAC securities required by the Board of Governors of the Federal Reserve (Federal Reserve Board) under subpart P of 12 CFR part 252. *See* proposed § 1.59A–1(b)(18) and (20). Specifically, proposed § 1.59A–3(b)(3)(v) provides that the amount excluded is no greater than the amount paid to foreign related parties multiplied by the scaling ratio, which is the average TLAC long-term debt required over the average TLAC security amount. The preamble to the proposed regulations requests comments regarding whether the TLAC exception should also apply to similar instruments issued by foreign corporations that are required by law to issue a similar type of loss-absorbing instruments. These instruments issued by foreign corporations would be relevant for section 59A if interest expense from those instruments is deducted by the U.S. branch or permanent establishment of the foreign corporation. Comments generally supported the exception for amounts paid to a foreign related party with respect to TLAC and suggested that the final regulations expand the exception to foreign issuers.

#### a. TLAC Issued in Compliance With Foreign Law

Comments requested that the TLAC exception be expanded to include TLAC issued to comply with foreign laws and regulations that are similar to the TLAC requirements prescribed by the Federal Reserve Board. One comment observed that an exception for interest on TLAC that is issued to comply with foreign

law and allocated to a U.S. branch or permanent establishment would provide branch parity, by excluding interest from base erosion payment status to the same extent, whether that internal TLAC debt is issued by a U.S. subsidiary or branch. See generally Rev. Proc. 2017–12, 2017–3 I.R.B. 424, for the definition of internal TLAC.

The Treasury Department and the IRS generally agree with comments that the special status of TLAC as part of the global system to address bank solvency applies equally to TLAC securities whether issued pursuant to U.S. law or foreign law. Consistent with comments, the final regulations expand the scope of the TLAC exception to include internal securities issued by GSIBs pursuant to laws of a foreign country that are comparable to the rules established by the Federal Reserve Board (“foreign TLAC”), where those securities are properly treated as indebtedness for U.S. federal income tax purposes.<sup>2</sup> In order to provide consistency between interest deductions on TLAC of a domestic subsidiary and a U.S. branch or permanent establishment, the final regulations limit the foreign TLAC exception to interest expense of GSIBs, and determine the limitation on the exception by reference to the specified minimum amount of TLAC debt that would be required pursuant to rules established by the Federal Reserve Board for TLAC if the branch or permanent establishment were a domestic subsidiary that is subject to Federal Reserve Board requirements. In addition, to ensure that the limitation is not greater than the amount required under foreign law, the final regulations express the limitation as the lesser of the hypothetical Federal Reserve Board limitation described in the preceding sentence and the specified minimum amount of TLAC debt that is required pursuant to bank regulatory requirements of a foreign country that are comparable to the requirements established by the Federal Reserve Board. Further, the Treasury Department and the IRS understand that in some jurisdictions, foreign TLAC may

apply in a more discretionary manner than the framework established in the proposed regulations that references the specified minimum amount of TLAC debt that is required pursuant to rules established by the Federal Reserve Board for TLAC of U.S. issuers, for example, with no specified minimum amount. For that reason, if the bank regulatory requirements of a foreign country do not specify a minimum amount, the limitation is determined by reference solely to the hypothetical Federal Reserve Board limitation. The second prong serves to provide general consistency with TLAC of a domestic subsidiary, by limiting the foreign TLAC exception to no more than the amount of TLAC that would be required by the Federal Reserve Board if the branch were a subsidiary (subject to the modification for a buffer that is also discussed in this Part IV.C.5.b). These rules tend to support the systemic bank solvency goals of TLAC by reducing the tax cost of issuing such securities via foreign related parties. The Treasury Department and the IRS understand that information necessary to determine this amount is generally knowable to banks with U.S. operations. The Treasury Department and the IRS also understand that in some foreign jurisdictions, the foreign TLAC requirements may apply to organizations other than GSIBs; however, to provide general consistency with interest deductions on TLAC of a domestic subsidiary, the final regulations limit the foreign TLAC exception to only GSIBs.

#### b. Buffer Amount Above Specified Minimum Amount

Comments also recommended that the final regulations increase the specified minimum amount of interest eligible for the TLAC exception to permit an additional “buffer” amount of TLAC that exceeds the minimum amount required to satisfy regulatory requirements (such as 115 percent of the specified minimum amount or a buffer equal to 1 to 1.5 percent of the risk-weighted assets). Comments explained that the inputs used to determine the minimum amount of TLAC needed to satisfy regulatory requirements change on a daily basis; as a result, the amount of TLAC securities needed also may change on a daily basis. The comments also noted that market issues dictate a certain lead time to issue TLAC securities. As a result, comments stated that it is the market expectation and practice that GSIBs operate with a buffer, which helps to ensure that TLAC does not fall below the minimum amount when risk-weighted assets or total leverage increase. Finally, the

comments asserted that because the cost of issuing TLAC securities significantly exceeds the cost of issuing non-loss absorbing securities, banks are commercially incentivized to issue no more TLAC securities than necessary.

Because of the special status of TLAC as part of a global system to address bank solvency and the specific requirements established by the Board and other regulators, the Treasury Department and the IRS recognize that it is necessary and appropriate to take into account the market practices that have been adopted to prevent TLAC from falling below the specified minimum amount as required by regulations. For these reasons, the final regulations adopt the recommendation to provide a 15 percent buffer on the specified minimum amount of interest eligible for the exception. This buffer applies for both TLAC and foreign TLAC.

#### c. Requests To Extend the TLAC Exception To Include Other Regulatory Capital Requirements

The Treasury Department and the IRS decline to expand the TLAC exception to cover interest payments on debt to foreign related parties that may satisfy regulatory capital requirements other than TLAC. The TLAC exception was adopted because of the unique role of TLAC securities in the global banking system for GSIBs; while other regulatory capital requirements may also serve an important role in bank regulation, the Treasury Department and the IRS are cognizant that the BEAT applies as a general matter to interest paid to foreign related parties, and have thus limited this regulatory exception to only those specific securities that are issued as part of the integrated international financial regulation and supervision system.

#### d. TLAC Issued During Transition Period

Comments recommended that the final regulations increase the specified minimum amount of interest eligible for the TLAC exception to permit interest with respect to TLAC debt in place during a three-year transition period before the year in which a corporation is required to have issued TLAC. The final regulations do not extend the TLAC exception to cover TLAC issued during a pre-effective date or transition period before being required to comply with the regulations prescribed by the Federal Reserve Board, because in that situation all of the debt is discretionary rather than mandatory. Further, there is no clear objective metric to scope discretionary issuances during a pre-effective period.

<sup>2</sup> While final regulations adopt the comment recommending similar treatment as between TLAC that is required under Federal Reserve Board regulations and similar foreign TLAC instruments, the final regulations do not address, and provide no inference, on whether those instruments issued pursuant to foreign law are treated as debt for U.S. federal income tax purposes. See Rev. Proc. 2017–12, 2017–3 I.R.B. 424 (providing generally that the IRS will treat as indebtedness internal TLAC that is issued by an intermediate holding company of a foreign GSIB pursuant to the Federal Reserve Board regulations, and that “[n]o inference should be drawn about the federal tax characterization of an instrument that is outside the scope of [Rev. Proc. 2017–12].”).

e. Other Operational Elements of the TLAC Exception

A comment recommended modifying the limitation on the exclusion for internal TLAC when a portion of the internal TLAC is held by the U.S. branch of a foreign person such that interest payments on the internal TLAC is also eligible for the ECI exception. The comment recommended that interest on the internal TLAC be first attributed to TLAC held by the U.S. branch of a foreign person, and thus excluded from the definition of a base erosion payment on the basis of the interest being ECI; and then only the incremental interest expense in excess of the amount payable to that branch would be subject to the TLAC scaling ratio limitation. The final regulations do not further expand the TLAC exception through such a rule, so as to retain the narrow scope of the TLAC exception to those securities that are required to be in place because of Federal Reserve Board requirements (taking into account the buffer described in this Part IV.C.5.b). The final regulations clarify the definition of TLAC securities amount to confirm that the TLAC scaling ratio applies without regard to whether TLAC interest is also eligible for another exclusion from base erosion payment status, and thus that the TLAC scaling ratio applies pro-rata to all internal TLAC. See § 1.59A-1(b)(19).

Another comment recommended that the final regulations modify the definition of the “TLAC long term debt minimum amount” to reflect international standards, rather than Federal Reserve Board requirements because the comment asserted that the Federal Reserve Board may, in the future, eliminate the minimum requirement in the Federal Reserve Board regulations. Comments also recommended expanding the TLAC exception to apply to other intercompany debt that is issued to comply with other bank regulatory capital requirements. The Treasury Department and the IRS have determined that it is appropriate to limit the amount of the TLAC exception by reference to Federal Reserve Board requirements, notwithstanding comments suggesting that in the future the Federal Reserve Board may eliminate its minimum required amount. If there are meaningful changes in the total loss absorbing capacity systems in the future, the Treasury Department and the IRS would be able to reassess the section 59A regulations.

Finally, a comment recommended that the final regulations should not exclude interest on TLAC borrowing

from the denominator of the base erosion percentage calculation, which is discussed in Part III of this Summary of Comments and Explanation of Revisions. The proposed regulations exclude from the denominator of the base erosion percentage amounts excluded under certain of the specific exceptions to base erosion payment status in § 1.59A-3(b) for SCM, QDP, and TLAC. This is in contrast to those amounts that are not base erosion payments because they are not within the main definition of a base erosion payment, for example, a payment to an unrelated third party, which remain in the denominator. The comment suggested that interest expense that is excluded from the definition of a base erosion payment under the TLAC exception should be viewed as like a payment to an unrelated third party, that is, the interest expense should remain in the denominator of the base erosion percentage. The comment premised this position on the view that internal TLAC should be viewed as issued to the holders of external TLAC (that is, to unrelated third party investors) under a theory that the issuer of internal TLAC is an intermediary or conduit for the issuer of the external TLAC securities. Therefore, there would be no underlying base erosion payment by the U.S. borrower on the internal TLAC, and thus the internal TLAC interest expense would remain in the denominator of the base erosion percentage calculation like interest paid to unrelated third parties. The proposed regulations and the final regulations provide a regulatory exception for internal TLAC on the basis of the special status of TLAC issued by GSIBs as part of the global system to address bank solvency. That is, the rationale for the TLAC exception in the proposed regulations and final regulations is not that the internal TLAC is a conduit for the external TLAC. For this reason, the final regulations (consistent with the proposed regulations) exclude from the denominator the TLAC interest in a manner consistent with the treatment of deductions covered by the SCM and QDP exceptions.

#### *D. Base Erosion Tax Benefits*

##### *1. Withholding Tax on Payments*

The proposed regulations provide that if tax is imposed by section 871 or 881, and the tax is deducted and withheld under section 1441 or 1442 without reduction by an applicable income tax treaty on a base erosion payment, the base erosion payment is treated as having a base erosion tax benefit of zero for purposes of calculating a taxpayer's

modified taxable income and base erosion percentage. If an income tax treaty reduces the amount of withholding imposed on the base erosion payment, the amount of the base erosion payment that is treated as a base erosion tax benefit is reduced in proportion to the reduction in withholding. In the regulation section pertaining to base erosion tax benefits, the final regulations include a technical correction to the fraction used to determine the amount of a base erosion payment that is treated as a base erosion tax benefit when the rate of withholding imposed on that payment is reduced by an income tax treaty. § 1.59A-3(c)(3)(i). To avoid duplication, the final regulation section pertaining to the base erosion percentage replaces a similar operating rule with a cross reference to the rule for determining base erosion tax benefits. See § 1.59A-2(e)(3)(iii).

Under section 884(f) and § 1.884-4, a portion of interest expense allocated to income of a foreign corporation that is, or is treated as, effectively connected with the conduct of a trade or business in the United States (“excess interest”) is treated as interest paid by a wholly-owned domestic corporation to the foreign corporation. The foreign corporation is subject to tax under section 881 on the excess interest and is required to report the excess interest on its income tax return, subject to the exemption provided in section 881 for bank deposit interest and reduction or elimination under applicable tax treaties. However, no withholding is required under section 1441 and 1442. See § 1.884-4(a)(2)(iv). Because no withholding is required, excess interest is not excluded from treatment as a base erosion tax benefit under the proposed regulations.

A comment suggested that because excess interest is subject to tax under section 881(a) as if it were interest paid to a foreign corporation by a wholly-owned domestic corporation, the exclusion from base erosion tax benefits that applies to payments subject to full withholding should also apply to excess interest. The comment suggested that the exclusion from treatment as a base erosion tax benefit might apply to excess interest under the proposed regulations, but requested clarification. While excess interest would not be excluded from treatment as a base erosion tax benefit under the proposed regulations because it is not subject to withholding, the Treasury Department and the IRS have determined that it is appropriate to expand the general exclusion from base erosion tax benefits to include excess interest. Accordingly, the final regulations reduce any base

erosion tax benefit attributable to interest in excess of interest on U.S.-connected liabilities by excess interest to the extent that tax is imposed on the foreign corporation with respect to the excess interest under section 884(f) and § 1.884-4, and the tax is properly reported on the foreign corporation's income tax return and paid in accordance with § 1.884-4(a)(2)(iv). § 1.59A-3(c)(2)(ii). If an income tax treaty reduces the amount of tax imposed on the excess interest, the amount of base erosion tax benefit under this rule is reduced in proportion to the reduction in tax.

The final regulations also provide a coordination rule to clarify the interaction between the withholding tax exception and the rules determining the portion of interest expense attributable to ECI that is treated as paid to a foreign related party. As discussed in part IV.B.4. of this Summary of Comments Explanation of Revisions, interest expense attributable to ECI that is in excess of direct allocations and interest expense on U.S.-booked liabilities is treated as paid to a foreign related party in proportion to the foreign corporation's average worldwide ratio of interest expense paid to a foreign related party over total interest expense. This coordination rule provides that any interest, including branch interest under § 1.884-4(b)(1), on which tax is imposed under 871 or 881 and tax has been deducted and withheld under section 1441 or 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 foreign corporation's average worldwide ratio.

## 2. Rule for Classifying Interest for Which a Deduction Is Allowed When Section 163(j) or Another Provision of the Code Limits Deductions

Section 59A(c)(3) provides a stacking rule in cases in which section 163(j) applies to a taxpayer, under which the reduction in the amount of deductible interest is treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to related parties. The statute does not provide a rule for determining which portion of the interest treated as paid to related parties (and thus potentially treated as a base erosion payment) is treated as paid to a foreign related party as opposed to a domestic related party. Proposed § 1.59A-3(c)(4) provides rules coordinating section 163(j) with the determination of the amount of base erosion tax benefits. This rule provides,

consistent with section 59A(c)(3), that where section 163(j) applies to limit the amount of a taxpayer's business interest expense that is deductible in the taxable year, a taxpayer is required to treat all disallowed business interest first as interest paid or accrued to persons who are not related parties, and then as interest paid or accrued to related parties for purposes of section 59A. More specifically, with respect to interest paid to related parties, the proposed regulations provide that the amount of allowed business interest expense is treated first as the business interest expense paid to related parties, proportionately between foreign and domestic related parties. Conversely, the amount of a disallowed business interest expense carryforward is treated first as business interest expense paid to unrelated parties, and then as business interest expense paid to related parties, proportionately between foreign and domestic related-party business interest expense.

Proposed § 1.59A-3(c)(4)(i)(C) provides that business interest expense paid or accrued to a foreign related party to which the ECI exception in proposed § 1.59A-3(b)(3)(iii) applies is classified as domestic related business interest expense. One comment observed that the proposed regulations do not expressly provide similar rules for business interest expense paid to foreign related parties that is excluded from the definition of a base erosion payment under the TLAC exception or excluded from the definition of a base erosion tax benefit under the exception for payments subject to withholding tax. The final regulations confirm that those categories of interest expense retain their classification as payments to foreign related parties, but also that the foreign related business interest expense category is treated as consisting of interest that is eligible for these exceptions and interest that is not eligible for these exceptions, on a pro-rata basis. See § 1.59A-3(c)(4)(i)(C)(2).

## E. Election To Waive Allowable Deductions

See the 2019 proposed regulations for a proposal to provide an election (and certain procedural safeguards) by which a taxpayer may permanently forego a deduction for all U.S. federal tax purposes, with the result that the foregone deduction will not be treated as a base erosion tax benefit.

## V. Comments and Changes To Proposed § 1.59A-4—Modified Taxable Income

Proposed § 1.59A-4 contains rules relating to the determination of modified taxable income.

## A. Method of Computing Modified Taxable Income

Section 59A(c)(1) defines modified taxable income as “the taxable income of the taxpayer computed under this chapter for the taxable year, determined without regard to—(A) any base erosion tax benefit with respect to any base erosion payment, or (B) the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year.” Proposed § 1.59A-4(b)(2) clarifies that modified taxable income is computed by adding back the base erosion tax benefits and base erosion percentage of any net operating loss deductions (the “add-back method”). In addition, to prevent net operating loss benefits from being duplicated, proposed § 1.59A-4(b)(1) provides that taxable income may not be reduced below zero as a result of a net operating loss deduction.

Comments generally recommended one of three approaches to calculate modified taxable income: (1) The add-back method, (2) the “recomputation method,” and (3) the “limited recomputation method.”

### 1. The Add-Back Method

Some comments recommended that the final regulations retain the add-back method because it would be simpler and easier to administer this method than a recomputation method. See Part V.A.2 of this Summary of Comments and Explanation of Revisions for a description of the recomputation method. Comments highlighted that the add-back method does not require attributes to be separately computed and tracked for regular income tax purposes and the BEAT. In addition, a comment asserted that this method more closely follows the statute, observing that the statutory language in section 59A(c) is substantially different from the recomputation-like language that was in section 59(a)(1)(B) relating to the foreign tax credit determination for alternative minimum tax purposes, which is now repealed for corporations. See section 59(a)(1)(B) (providing explicit language referencing computing the alternative minimum tax foreign tax credit as if section 904 were applied on the basis of alternative minimum taxable income instead of taxable income); see also the Act, § 12001(a) (repealing the alternative minimum tax for corporations and rendering section 59(a)(1)(B) inapplicable to corporations). Another comment noted that the add-back method is harmonious with the language of section 59A(c)(1)(B) because that section includes the base erosion percentage of net operating loss

deductions as an item included in modified taxable income as the method for determining which portion of net operating loss carryovers from prior years resulted from base erosion tax benefits. (Under a recomputation method with a net operating loss carryover that is computed on a BEAT basis, base erosion tax benefits would already be excluded from the net operating loss carryover, so it would be anomalous to also apply section 59A(c)(1)(B) to the net operating loss deduction.) In support of the add-back method, one comment asserted that applying a recomputation approach would exceed statutory authority.

## 2. The Recomputation Method

Some comments recommended that the final regulations determine modified taxable income by using the recomputation method that is described in the preamble to the proposed regulations whereby the taxpayer's taxable income is recomputed without the excluded items, or a variation of that method. See REG-104259-18, 83 FR 65965 (December 21, 2018) (describing a recomputation approach as requiring attributes that are limited based on taxable income to be recomputed for purposes of section 59A). For example, some comments recommended making the recomputation method elective. One comment requested a recomputation method with a special rule for net operating loss deductions, which is discussed in Part V.A.3 of this Summary of Comments and Explanation of Revisions (limited recomputation method). While comments acknowledged that the add-back method is less complex, comments asserted that the add-back method may result in greater BEAT liability. Comments claimed that the recomputation method more accurately computes the base erosion minimum tax amount ("BEMTA"). Comments also asserted that the language in section 59A(c)—specifically the clause "computed without regard to"—is more consistent with the recomputation method. Another comment noted that nothing in section 59A or its legislative history mandates the use of the add-back method and that taxpayers familiar with the prior corporate alternative minimum tax would have anticipated using the recomputation method.

Additionally, some comments requested a recomputation method with a separate tracking of attributes such as net operating loss carryovers, while others requested a recomputation method without a separate tracking of attributes. Some comments acknowledged that the recomputation

method could give taxpayers a double benefit from non-base eroding deductions unless it required separate tracking of attributes for purposes of the BEAT. For example, one comment noted that the recomputation method would generally allow net operating loss carryovers to be used more rapidly for purposes of modified taxable income than for regular tax purposes because the taxable income limitation under section 172 on net operating loss deductions would be lower for regular tax purposes. As a result, the comment noted that if net operating loss carryovers are not separately tracked for purposes of the BEAT, a taxpayer may receive a double benefit from the non-base eroding deductions because those attributes reduce modified taxable income in the loss year, but if the attributes do not reduce the taxpayer's regular tax liability, the attributes would remain available to reduce modified taxable income in a future year. In contrast, another comment asserted that attributes should not be separately tracked because section 59A requires a snapshot of relative tax attributes that are applied independently to calculate taxable income and modified taxable income.

## 3. The Limited Recomputation Method

Some comments recommended that the final regulations permit a taxpayer to elect to recompute its taxable income with respect to pre-2018 net operating loss carryovers (the "limited recomputation method"). Under this approach, comments generally suggested the taxpayer would use the add-back method except with respect to pre-2018 net operating loss carryovers, which would be separately used and tracked for purposes of the BEAT. One comment suggested that this approach should apply to net operating losses generally, not only pre-2018 net operating loss carryovers. Comments asserted that the proposed regulations have the effect of denying some taxpayers the economic benefit of their pre-2018 net operating loss carryovers because they do not allow pre-2018 net operating loss carryovers to offset full tax liability of taxpayers. Some comments acknowledged that using net operating loss carryovers under any of the three methods discussed in this Part V.A of the Summary of Comments and Explanation of Revisions are timing differences (rather than permanent differences that would deny economic benefit) because pre-2018 net operating loss carryovers are allowed against modified taxable income as and when those net operating loss carryovers are deducted for regular tax purposes.

Comments generally asserted that limiting the utilization of net operating loss carryovers is arguably retroactive in nature because it limits the tax benefit of pre-2018 net operating loss carryovers and is unduly harsh because it may cause a taxpayer to pay tax on an amount greater than its economic income. Some comments also asserted that the limited recomputation approach is more consistent with pre-Act section 172 and the policies supporting section 59A. The comments noted that the section 172 legislative history suggests that net operating loss deductions were allowed primarily to alleviate economic losses incurred by taxpayers and asserted that absent clear statutory language and expressed legislative intent to limit the use of net operating losses, taxpayers should be able to use the net operating loss carryovers without limitation in calculating their modified taxable income. However, the comment acknowledged that an attribute tracking system is required to prevent the same net operating loss carryovers from being deducted multiple times for the BEAT.

## 4. Add-Back Method Retained in Final Regulations

The final regulations retain the add-back method. The add-back method takes into account all the statutory language in section 59A(c)(1), which determines modified taxable income without regard to both the base erosion tax benefits and the base erosion percentage of net operating loss deductions. This approach is also consistent with the Joint Committee on Taxation's Explanation of the Act, which states that "an applicable taxpayer's modified taxable income is its taxable income for the taxable year, *increased by* (1) any base erosion tax benefit with respect to any base erosion payment and (2) the base erosion percentage of any NOL deduction allowed under section 172 for such taxable year." Joint Comm. on Tax'n, General Explanation of Public Law 115-97 ("Bluebook"), at 403 (emphasis added). By contrast, the recomputation method conflicts with section 59A(c)(1). If taxable income is recomputed without any base erosion tax benefits for modified taxable income, it is a necessary premise that net operating loss carryovers would also be recomputed as BEAT-basis attributes, which, under the recomputation framework, would not include the effect of any base erosion tax benefits (because the recomputation method is without regard to base erosion tax benefits). However, that framework would make the language in section 59A(c)(1)(B)

superfluous or inexplicable because section 59A(c)(1)(B) addresses the percentage of base erosion tax benefits embedded in a net operating loss carryover, whereas a recomputed BEAT-basis net operating loss carryover would already exclude all base erosion tax benefits.<sup>3</sup>

Further, as some comments noted, the add-back method is more consistent with the statutory framework of section 59A because the add-back method does not require additional rules regarding the treatment of separate tax attributes. The Treasury Department and the IRS

<sup>3</sup> For example, assume that a domestic corporation (DC) is an applicable taxpayer that has a calendar year. In 2020, DC has gross income of \$0, a deduction of \$60x that is not a base erosion tax benefit, and a deduction of \$40x that is a base erosion tax benefit. For regular tax purposes, DC has a net operating loss carryover within the meaning of section 172(b) of \$100x. DC also has a base erosion percentage of 40 percent for the 2020 taxable year. Under the recomputation method, DC's taxable income would presumably be recomputed without regard to base erosion tax benefits, and as a result, DC would presumably have a BEAT-basis net operating loss carryover of \$60x, computed as DC's excess of deductions over gross income, without regard to the \$40x of deductions that are base erosion tax benefits.

Assume further that in 2021, DC has gross income of \$70x, and no current year deductions. For regular tax purposes, DC is permitted a net operating loss deduction of \$56x (section 172(a) limits the regular tax deduction for net operating losses that originated after the Act to 80 percent of taxable income before the net operating loss deduction), and thus DC has regular taxable income of \$14x (\$70x - \$56x = \$14x). Under the add-back method, DC's modified taxable income for 2021 would be computed as \$36.4x, computed as regular taxable income of \$14x, plus \$0 base erosion tax benefits in 2021, plus the section 59A(c)(1)(B) base erosion percentage of the net operating loss allowed under section 172, \$22.4x (\$56x × 40 percent = \$22.4x).

Under the recomputation method, DC would presumably need to recompute its 2021 taxable income *without regard to its base erosion tax benefits in 2021* (there are none in the example) and also *without regard to the base erosion percentage of the net operating loss deduction allowed under section 172 for the taxable year (\$56x)*. Section 59A(c)(1)(B). However, the basic premise of the recomputation method is that DC has a BEAT-basis net operating loss carryover from 2020 of \$60x that already excludes the 2020 base erosion tax benefits. DC's modified taxable income for 2021 might thus be computed as \$14x (\$70x gross income, reduced by \$56x, which is the lesser of (i) the \$60x BEAT-basis net operating loss carryover from 2020 or (ii) 80 percent of the taxable income (\$70x) computed without regard to the section 172 deduction, or \$56x). However that adaptation would render section 59A(c)(1)(B) irrelevant. If instead, section 59A(c)(1)(B) was taken into account in computing DC's modified taxable income, then DC's modified taxable income would include the erosion percentage (40 percent) of the BEAT-basis net operating loss carryover from 2020 (\$60x), even though that BEAT-basis net operating loss carryover has already been stripped of any 2020 base erosion tax benefits. Thus, this adaptation that gives regard to section 59A(c)(1)(B) would seem to incongruously increase modified taxable income by \$24x (40 percent of \$60x = \$24x). Some comments observed these anomalies, but no comments appear to provide a complete reconciliation of how the recomputation method would address the anomalies under the terms of the statute.

have determined, and numerous comments acknowledged, that if the recomputation method were used, separate tracking of attributes would be required to avoid duplication of benefits. Unlike the alternative minimum tax that was repealed for corporations, the BEAT does not contain rules to address how a recomputation method would be implemented, including in the case of a section 381 transaction, a section 382 ownership change, or a deconsolidation. Thus, the recomputation methods would require the Treasury Department and the IRS to construct such rules by regulation. Moreover, as also identified by comments, the add-back method is simpler and easier to comply with and administer for both taxpayers and the IRS than the recomputation method or other methods (including a method by which a taxpayer could elect to apply the add-back or recomputation method) because the recomputation-based methods would require the taxpayer to calculate an entire parallel tax return and schedules to take into account iterative effects, whereas the add-back approach only requires addition, rather than iterative effects. As a result of these factors, the Treasury Department and the IRS have determined that it is not appropriate to permit the recomputation method.

These reasons for rejecting the recomputation method also apply to the limited recomputation method. Because the recomputation approach generally is not consistent with the statutory construct, it would be inappropriate to create a limited version of that approach to permit a taxpayer to use its pre-2018 net operating loss carryovers or all net operating loss carryovers. Section 59A does not provide special rules or preferences for pre-2018 net operating loss carryovers. In addition, the comments' assertions for pre-2018 net operating loss carryovers generally apply to subsequent net operating loss carryovers of certain taxpayers, and those carryovers would raise all the issues discussed.

The claim that taxpayers are losing the benefit of their net operating loss carryovers as a result of the add-back method in the proposed regulations is erroneous. Net operating loss carryovers continue to offset regular taxable income. Section 59A does not change that result, as the net operating loss deduction is allowed against modified taxable income as and when deducted for regular tax purposes. Section 172 does not provide that if a taxpayer has a net operating loss carryover then the taxpayer does not have to pay any taxes under any provision. Because the base

erosion percentage of any net operating loss deduction is taken into account in determining modified taxable income, section 59A(c)(1)(B) specifically contemplates that a taxpayer may not obtain the full benefit of net operating loss carryovers even in a year in which the taxpayer uses a net operating loss deduction to fully offset taxable income for purposes of its regular tax liability.

Moreover, the statutory language in section 59A does not explicitly limit that provision to net operating loss deductions related to carryovers that originated in tax years beginning after December 31, 2017; rather, that limitation resulted from the vintage year approach adopted in proposed § 1.59A-4(b)(2)(ii). Absent that provision, or if proposed § 1.59A-4(b)(2)(ii) had adopted a current year base erosion percentage approach, the add-back provision in section 59A(c)(1)(B) could have also applied to net operating loss deductions related to carryovers that originated in pre-2018 tax years. See Part V.B of this Summary of Comments and Explanation of Revisions for a discussion of the comments related to proposed § 1.59A-4(b)(1) and limiting the net operating loss deduction for purposes of computing modified taxable income.

#### *B. Amount of Net Operating Loss Deduction From Net Operating Loss Carryovers*

Under the add-back method, section 59A(c) provides that the computation of modified taxable income starts with the taxpayer's regular taxable income for the year. Section 172(a) generally provides that for regular tax purposes a deduction is allowed for the tax year in an amount equal to the net operating loss carryover to the year. For net operating loss carryovers originating after the Act, the net operating loss deduction is generally limited for regular tax purposes to 80 percent of taxable income computed without regard to the net operating loss deduction. Section 172(a). For net operating loss carryovers originating before the Act, the net operating loss carryover deduction generally is not limited for regular tax purposes. Section 13302(e)(1) of the Act. Proposed § 1.59A-4(b)(1) provides that taxable income may not be reduced below zero as a result of net operating loss deductions. The preamble to the proposed regulations explains that the rule is necessary because section 172(a) could be read to provide that the same net operating loss carryover could reduce modified taxable income in multiple years. REG-104259-18, 83 FR 65965 (December 21, 2018).



The preamble to the proposed regulations provides an example where a taxpayer has a net operating loss carryover of \$100x that arose in a taxable year beginning before January 1, 2018. REG-104259-18, 83 FR 65965 (December 21, 2018). In a subsequent year, the taxpayer has taxable income of \$5x before taking into account the \$100x net operating loss carryover. Absent the rule in proposed § 1.59A-4(b)(1), the taxpayer might claim the entire \$100x net operating loss carryover as a \$100x deduction in that year to create a \$95x taxable loss for determining modified taxable income, even though \$95x of the net operating loss carryover would remain as a carryover to future years. Proposed § 1.59A-4(b)(1) ensures that a net operating loss is taken into account only once in determining a taxpayer's modified taxable income.

Some comments recognized the need for proposed § 1.59A-4(b)(1) consistent with the preamble to the proposed regulations. A comment acknowledged that if the net operating loss carryover deductions are not limited to the amount of taxable income, those net operating losses could reduce taxable income—and therefore the taxpayer's BEAT liability—multiple times. Another comment noted that, without proposed § 1.59A-4(b)(1), allowing net operating loss carryovers to be taken into account for modified taxable income to the same extent as general taxable income would give rise to certain complex questions concerning net operating loss carryovers for general tax purposes.

Other comments asserted that there is no authority in section 59A for limiting the net operating loss deduction to the amount of taxable income, that the rule in proposed § 1.59A-4(b)(1) is contrary to the statute, and that the final regulations should permit taxable income to be negative as a result of net operating loss carryovers. Comments noted that modified taxable income is determined based on taxable income, which generally is gross income minus deductions allowed under chapter 1, including the net operating loss deduction. Another comment noted that with respect to the amount of net operating loss deduction in a taxable year, when Congress wants to place a floor on a number, it does so expressly; for example, section 59A(b)(1)(B) provides that regular tax liability is “reduced (but not below zero).” In contrast, there is no similar language in section 59A or section 172(a) prior to the Act for net operating loss deductions.

Comments also asserted that the limitation on the use of net operating loss carryovers as deductions in a

taxable year causes taxpayers to be liable for tax pursuant to the BEAT on their base erosion tax benefits even though they are not liable for regular income tax because of their net operating loss deductions that reduced regular taxable income to zero. Comments also asserted that the proposed regulations effectively reduce the extent to which the net operating loss carryforwards may be used.

Other comments requested that the final regulations provide a transition to the proposed rule preventing taxable income to be negative as a result of a net operating loss deduction. One comment requested that final regulations provide for a deferral of the effective date of proposed § 1.59A-4(b)(1) of one or two years. Another comment requested that final regulations provide that taxpayers may reduce their BEAT liability by (a) an amount equal to the pre-2018 net operating loss carryover that offset taxable income, multiplied by (b) the difference between the regular income tax rate and the BEAT rate because section 59A should not retroactively reduce the value of the pre-2018 net operating loss carryovers. These comments also highlighted a situation where a taxpayer's regular taxable income is reduced entirely by available pre-2018 net operating loss carryovers, but the taxpayer also has base erosion tax benefits that increase modified taxable income, causing a BEAT liability. The comments asserted that imposing BEAT on this modified taxable income amounts to a retroactive reduction in the value of the taxpayer's pre-2018 net operating loss carryovers, and recommended that the final regulations adopt this methodology by which pre-2018 attributes are provided a 21 percent tax rate benefit, which is similar to the limited recomputation method discussed in Part V.A of this Summary of Comments and Explanation of Revisions.

These comments are not adopted in the final regulations. First, the comments focused on a technical reading of section 172(a) as it applies to net operating loss carryovers that originated before the Act. That version of section 172(a) did not expressly limit the amount of net operating loss deduction for regular tax purposes to 100 percent of taxable income computed without regard to the net operating loss deduction. As it existed before the Act, there was no reason to limit the section 172(a) deduction in this manner because before the Act there was no consequence to claiming a net operating loss deduction greater than 100 percent of current year taxable income. For example, before the Act, a taxpayer's net

operating loss carryover was only reduced by the amount of net operating loss deduction that was actually used to reduce taxable income to zero. *See* § 1.172-4(a)(3).

In addition to the technical reading of section 172(a) as it applies to net operating loss carryovers that originated before the Act, the Treasury Department and the IRS continue to believe, consistent with some of the comments received, that limiting net operating loss deductions to the amount of taxable income for purposes of computing modified taxable income is necessary and appropriate to prevent net operating loss carryovers from being used multiple times to reduce modified taxable income. If the final regulations did not limit the amount of net operating loss carryover deductions for purposes of calculating modified taxable income, a taxpayer with a large pre-2018 net operating loss carryover would be able to reduce modified taxable income in multiple years with the same net operating loss carryover, without reducing the net operating loss carryover for regular income tax purposes.

The fact that taxpayers with sufficiently large pre-2018 net operating loss carryovers may be able to avoid paying regular income tax in a taxable year does not mean that those taxpayers should be permitted to offset the entire amount of their BEAT liability in that taxable year, or in other words, not be liable for tax under the BEAT. As discussed in Part V.A. of this Summary of Comments and Explanation of Revisions, the limitation on net operating loss deductions for determining modified taxable income impacts only the BEMTA. This limitation does not prevent the use of pre-2018 net operating loss carryover to reduce regular taxable income to zero. Further, to the extent a taxpayer's pre-2018 net operating loss carryovers exceed the taxpayer's taxable income, the taxpayer continues to use those remaining net operating loss carryovers in later years to offset some or all regular taxable income; and the taxpayer continues to reduce modified taxable income by the same amount in those later years.

A comment asserted that the add-back method creates an economic disparity between similarly situated taxpayers because taxpayers without pre-2018 net operating loss carryovers can make more base erosion payments than taxpayers with pre-2018 net operating loss carryovers before being subject to BEAT liability. However, taxpayers with pre-2018 net operating loss carryovers are not similarly situated to taxpayers

without pre-2018 net operating loss carryovers, as the former are paying less regular income taxes than the latter, which is a factor in determining the amount of BEAT liability.

One comment questioned why current year losses can result in negative taxable income for BEAT purposes, while net operating losses that are carried to a different year cannot result in negative taxable income in that different year. Proposed § 1.59A-4(b)(1) permits taxpayers that have current year losses to use that negative income amount as a starting point for computing modified taxable income because the Treasury Department and the IRS determined that if taxpayers were not permitted to use that negative amount as a starting point for calculating modified taxable income, the base erosion tax benefits for that year could be double counted. That is, the base erosion tax benefits for that year could be included in modified taxable income for the current year and in the year the net operating loss carryover is used because of the add-back of the base erosion percentage of the net operating loss deduction in the year used. Because of this concern, the proposed regulations expressly permit current year losses to be taken into account as the starting point for computing modified taxable income. Proposed §§ 1.59A-4(b)(1) and (c).

Section 59A(i) provides a broad grant of regulatory authority, permitting the Secretary to prescribe regulations as may be necessary or appropriate to carry out the provisions of the section. For the reasons discussed, the Treasury Department and the IRS have determined that limiting the net operating loss deduction to taxable income in computing modified taxable income is within the grant of authority, and the final regulations do not adopt the comments requesting a different rule. The final regulations also do not adopt a rule providing a fixed 21 percent tax rate benefit for all pre-2018 net operating loss carryovers. The fact that a taxpayer may have positive modified taxable income (resulting in a positive BEAT tax liability) even if the taxpayer has a lesser amount of regular taxable income because pre-2018 net operating loss carryovers reduce taxable income is a part of the statutory framework of the BEAT; that is, imposing tax on a modified taxable income base. See also, the response to the limited recomputation method discussed in Part V.A of this Summary of Comments and Explanation of Revisions.

#### *C. Use of Aggregate Base Erosion Percentage for Net Operating Loss Deductions*

Proposed § 1.59A-4(b)(1) generally defines modified taxable income as a taxpayer's taxable income computed under chapter 1, determined without regard to base erosion tax benefits and the base erosion percentage of any net operating loss deduction under section 172 for the taxable year. Under the proposed regulations, the base erosion percentage for the year that the net operating loss carryover arose (the "vintage year" base erosion percentage) is used to compute modified taxable income. Proposed § 1.59A-4(b)(2)(ii). Although the computation of modified taxable income is made on a taxpayer-by-taxpayer basis, the proposed regulations clarify that in computing the add-back for net operating loss deductions, the relevant base erosion percentage is the base erosion percentage for the aggregate group, which is used to determine whether the taxpayer is an applicable taxpayer.

A comment noted that an aggregate base erosion percentage could potentially take into account deductions of another aggregate group member that are not otherwise included in a taxpayer's return. The comment questioned whether a more precise determination of a taxpayer's vintage year base erosion percentage is appropriate.

The Treasury Department and the IRS have determined that the base erosion percentage that is applied to net operating loss deductions when computing modified taxable income should be computed on the basis of the taxpayer and its aggregate group in the same manner as the base erosion percentage that is computed for determining whether the taxpayer is an applicable taxpayer under section 59A(e). Section 59A(e)(3) requires aggregation for purposes of computing the base erosion percentage that is used to determine whether a taxpayer is an applicable taxpayer and to determine the portion of net operating loss deductions that are included in computing modified taxable income pursuant to section 59A(c)(1)(B). Because Congress chose to determine the base erosion percentage on an aggregate basis, it follows that one aggregate group member's deductions can affect the base erosion percentage that will apply with respect to another member of the group. For these reasons, the final regulations do not revise the rules for determining the base erosion percentage that is applied to net

operating loss deductions when computing modified taxable income.

#### *D. Operation of Vintage Approach for Net Operating Losses*

Section 59A(c)(1)(B) provides that modified taxable income includes the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year. Proposed § 1.59A-4(b)(2)(ii) provides that the base erosion percentage of the year in which the loss arose, or the "vintage year," is used to compute modified taxable income rather than the base erosion percentage in the year in which the taxpayer takes the net operating loss deduction.

One comment requested guidance on how the vintage year approach is applied when in the vintage year the taxpayer has both deductions that are base erosion tax benefits and deductions that are not base erosion tax benefits. The comment stated that it is not clear how to compute or order the base erosion percentage because the proposed regulations do not provide rules for determining which type of deductions were used in that vintage year to offset gross income, and which deductions were carried forward as net operating loss carryforwards. The comment provided an example in which the taxpayer in year 1 has gross income of \$800x and deductions of \$1000x that consist of \$250x of base erosion tax benefits and \$750x of non-base erosion tax benefits, resulting in a \$200x net operating loss. The comment requested clarification for determining how the deductions are ordered for determining the base erosion percentage of the year 1 \$200x net operating loss carryover when that carryover is deducted in a later year.

The final regulations do not revise the vintage year rule because section 59A(c)(1)(B) and the proposed regulations already provide that the base erosion percentage used with respect to the net operating loss deduction is the base erosion percentage of the taxpayer in the relevant taxable year (in this example,  $\$250x/\$1000x = 25$  percent). That is, no specific ordering rule is required because the base erosion percentage calculation for the vintage year takes into account a proportionate amount of each type of deduction (or \$250x divided by \$1000x in the example).

Another comment suggested that in applying the vintage year approach to net operating loss deductions, a simplifying convention should be provided to address target corporations that have net operating loss carryovers and become members of a taxpayer's

aggregate group by acquisition. The comment suggested that taxpayers be permitted to elect to use their current year base erosion percentage with respect to the net operating loss deductions, rather than the vintage year base erosion percentage of the target because it may be complicated to determine the target's vintage year base erosion percentage. The comment specifically noted the difficulty in cases where the target was not an applicable taxpayer in the vintage year. The final regulations do not adopt this elective approach. Because the net operating loss carryover is an attribute of the target corporation, the target corporation is required to maintain documentation to support both the carryover amount and the other aspects of its attributes that affect the target corporation's tax liability—namely the base erosion percentage with respect to its net operating loss carryovers. Accordingly, the acquiring corporation should be able to obtain the information necessary to determine the target corporation's vintage year base erosion percentage.

#### **VI. Comments and Changes to Proposed § 1.59A-5—BEMTA**

Proposed § 1.59A-5 contains rules regarding the calculation of BEMTA and provides the base erosion and anti-abuse tax rate that applies to the taxpayer's taxable year. The proposed regulations provide that an applicable taxpayer computes its BEMTA for the taxable year to determine its liability under section 59A(a). Proposed § 1.59A-5(b). Generally, the taxpayer's BEMTA equals the excess of (1) the applicable tax rate for the taxable year ("BEAT rate") multiplied by the taxpayer's modified taxable income for the taxable year over (2) the taxpayer's adjusted regular tax liability for that year. Proposed § 1.59A-5(b). In determining the taxpayer's adjusted regular tax liability for the taxable year, credits (including the foreign tax credit) are generally subtracted from the regular tax liability amount. Proposed § 1.59A-5(b)(2). Consistent with section 59A(b)(1)(B), the proposed regulations provide that for taxable years beginning before January 1, 2026, the credits allowed against regular tax liability (which reduce the amount of regular tax liability for purposes of calculating BEMTA) are not reduced by the research credit determined under section 41(a) or by a portion of applicable section 38 credits.

To prevent an inappropriate understatement of a taxpayer's adjusted regular tax liability, the proposed regulations provide that credits for overpayment of taxes and for taxes

withheld at source are not subtracted from the taxpayer's regular tax liability because these credits relate to U.S. federal income tax paid for the current or previous year. Proposed § 1.59A-5(b)(3)(i)(C) and (ii).

#### **A. Applicability of Aggregation Rule to BEMTA**

The proposed regulations provide that the computations of modified taxable income and BEMTA are done on a taxpayer-by-taxpayer basis. That is, the aggregate group concept is used solely for determining whether a taxpayer is an applicable taxpayer, and does not apply to the computations of modified taxable income and the BEMTA. The preamble to the proposed regulations explains that if taxpayers calculated BEMTA differently depending on their differing views of the base on which the BEAT should be calculated (that is, aggregate group, consolidated group, individual company), this could lead to inequitable results across otherwise similar taxpayers. REG-104259-18, 83 FR 65974 (December 21, 2018).

The proposed regulations also explain that it is expected to be less costly for taxpayers to calculate BEMTA on a taxpayer-by-taxpayer basis because the statutory framework of section 59A applies in addition to the regular tax liability of a taxpayer. Calculating BEAT liability at an aggregate level, for example, would require any BEAT liability to be reallocated among the separate taxpayers.

Comments requested that electing taxpayers be permitted to apply the aggregation rules of section 59A(e)(3) to determine their modified taxable income and BEMTA. Electing taxpayers would effectively compute modified taxable income and BEMTA at the level of the aggregate group rather than at the level of the separate taxpayer.

The comments explained that aggregation would permit a group with multiple consolidated returns to be given full credit for the group's contributions to the U.S. tax base. Comments further explained that, in certain instances, business, legal, or regulatory reasons prevent groups with multiple taxpayers from forming an affiliated group of corporations within the meaning of section 1504 that can file a single consolidated return. However, the comments asserted that these groups still represent a single economic unit where they have a common parent and overall management, share services, and are generally treated as a single employer.

Comments also suggested that an election to apply the aggregation rules for BEMTA would prevent inequitable

results in the application of the BEAT. For example, some comments suggested that it would be inequitable for a single consolidated group within an aggregate group that had a large amount of NOLs, minimal regular tax liability, and little to no base erosion payments to be subject to the BEAT as a result of a separate consolidated group's high base erosion percentage.

The comments suggested that an aggregate approach would result in an insignificant amount of additional complexity and little additional burden to taxpayers and the government. Comments also made suggestions regarding particular requirements of the election, such as requirements that each taxpayer joining the election have the same taxable year-end, agree to provide the IRS with all information needed to compute the aggregate BEAT liability, agree to be allocated a pro-rata share of the aggregate BEAT liability, and give consent for the statute of limitations to remain open until the audits of all group members with respect to the information used to determine that aggregate BEAT liability have closed.

The final regulations do not adopt the recommendations. The Treasury Department and the IRS recognize that, in determining whether a taxpayer is an applicable taxpayer, and for determining certain computational matters relating to modified taxable income and the BEMTA, section 59A applies by reference to the taxpayer and the members of its aggregate group. Section 59A does not explicitly extend that aggregate group treatment to the computation of a taxpayer's BEMTA or the resulting tax liability. The rules relating to the aggregate group concept are complex, and they produce meaningful differences from the single-entity concepts in the consolidated return regulations. See Part III of this Summary of Comments and Explanation of Revisions. Section 1502 and the regulations thereunder contain detailed rules for implementing the single taxpayer elements of the consolidated return regulations. No similar rules are expressly contemplated in section 59A with respect to BEMTA. Adding similar rules to these final regulations would add significant complexity and would require the IRS to audit a parallel BEMTA computation system. Consistent with section 1502 and the regulations thereunder, aggregate groups of taxpayers that file a consolidated return must compute BEMTA on a single-entity basis under section 59A and the final regulations. See § 1.1502-59A(b). Therefore, the final regulations continue to provide that BEMTA is calculated on a taxpayer-by-taxpayer basis.

### *B. Treatment of General Business Credits and Foreign Tax Credits*

A comment noted that taxpayers may have credits generated in taxable years beginning before January 1, 2018, that carry forward to be used in taxable years beginning after December 31, 2017. In the case of net operating losses that arose in taxable years beginning before January 1, 2018, and that are deducted as carryovers in taxable years beginning after December 31, 2017, the comment also noted that proposed § 1.59A–4(b)(2)(ii) provides that those deductions are excluded from modified taxable income.

The comment requested that the final regulations exclude section 38 credits and foreign tax credits generated in pre-2018 taxable years from the definition of credits allowed under chapter 1 of the Code. As a result of this request, these credits would not be subtracted from the regular tax liability amount in determining BEMTA. Alternatively, the comment requested that the partial exclusion of section 38 credits from the calculation of BEMTA in proposed § 1.59A–5(b)(3)(i)(B) be extended to foreign tax credits.

The final regulations do not adopt this comment. With respect to net operating losses that arose in taxable years beginning before January 1, 2018, the exclusion of these deductions from the calculation of modified taxable income results from two statutory elements: (i) Section 59A(c)(1) provides that the starting point for modified taxable income is “taxable income of the taxpayer computed under [chapter 1 of the Code] for the taxable year . . .”; that is, modified taxable income starts with taxable income, as reduced for any net operating loss deduction under section 172; and (ii) section 59A(c)(1)(B) provides that modified taxable income includes, or adds back to taxable income, the base erosion percentage of any NOL deduction under section 172 for the taxable year. This statutory framework for determining modified taxable income establishes that section 59A permits the net operating loss deduction to reduce some or all of the current year’s pre-NOL taxable income, but that a portion of the tax benefit from that NOL deduction is added back to taxable income. Further, § 1.59A–4(b)(2)(ii) applies the base erosion percentage of the year in which the loss arose for this purpose, which effectively means that net operating losses incurred in taxable years ending on or before December 31, 2017, are entirely excluded from the calculation from modified taxable income when those deductions are used to reduce or

eliminate regular taxable income. In contrast to this explicit statutory framework that addresses the lifecycle of the net operating loss carryforward, section 59A does not provide a similar rule for credits. Instead, section 59A(b)(1)(B) provides that all credits allowed under chapter 1 of the Code against regular taxable income for the taxable year are excluded from the calculation of BEMTA, except for specifically enumerated credits that are partially or fully allowed to reduce BEMTA. Because section 59A(b)(1) refers to all credits allowed to reduce taxable income during the taxable year and makes no distinction as between those credits that originated in the current taxable year or a prior taxable year, the Treasury Department and the IRS have determined that the proposed regulations are consistent with the statute, and the final regulations retain the same rules with respect to section 38 credits and foreign tax credits.

### *C. Exclusion of AMT Credits From Credits Reducing Regular Tax Liability*

Generally, a taxpayer’s BEMTA equals the excess of (1) the applicable tax rate for the year multiplied by the taxpayer’s modified taxable income for the taxable year over (2) the taxpayer’s adjusted regular tax liability for that year. In determining the taxpayer’s adjusted regular tax liability for the taxable year, credits are generally subtracted from the regular tax liability amount. To prevent an inappropriate understatement of a taxpayer’s adjusted regular tax liability, the proposed regulations provide that credits for overpayment of taxes and for taxes withheld at source are not subtracted from the taxpayer’s regular tax liability because these credits relate to U.S. federal income tax paid for the current or previous year.

Historically, an alternative minimum tax (“AMT”) was imposed on a corporation to the extent the corporation’s tentative minimum tax exceeded its regular tax. If a corporation was subject to AMT in any year, the amount of AMT was allowed as an AMT credit in any subsequent taxable year to the extent the corporation’s regular tax liability exceeded its tentative minimum tax in the subsequent year. Bluebook, pp. 92, 94.

The Act repealed the corporate AMT, and allows the corporate AMT credit to offset the entire regular tax liability of the corporation for a taxable year. In addition, the AMT credit is allowable and generally refundable for a taxable year beginning after 2017 and before 2022 in an amount equal to 50 percent (100 percent in the case of taxable years beginning in 2021) of the excess (if any)

of the minimum tax credit for the taxable year over the amount of the credit allowed for the year against regular tax liability. Bluebook p. 97.

Comments requested that AMT credits be excluded from the calculation of credits that reduce adjusted regular tax liability because they represent income taxes imposed in a previous tax year and allowed as credits in a subsequent tax year. The Treasury Department and the IRS agree with these comments. Accordingly, § 1.59A–5(b)(3) provides that AMT credits, like overpayment of taxes and for taxes withheld at source, do not reduce adjusted regular tax liability for purposes of section 59A.

### *D. Rules Relating to Banks and Registered Securities Dealers for Purposes of Computing the Base Erosion Percentage and Determining the BEAT Rate for Computing BEMTA*

Generally, under proposed § 1.59A–2(e)(1), a taxpayer, or the aggregate group of which the taxpayer is a member, satisfies the base erosion percentage test to determine applicable taxpayer status if its base erosion percentage is at least three percent. However, section 59A(e)(1)(C) and proposed § 1.59A–2(e)(2)(i) provide that a lower threshold of two percent applies if the taxpayer is a member of an affiliated group (as defined in section 1504(a)(1)) that includes a domestic bank or registered securities dealer. Proposed § 1.59A–2(e)(2)(ii) applies this two-percent threshold to the aggregate group of which a taxpayer is a member that includes a bank or registered securities dealer that is a member of an affiliated group. Proposed § 1.59A–2(e)(2)(iii) provides a de minimis exception to this lower two-percent base erosion percentage threshold in the case of an aggregate group or consolidated group that has de minimis bank or registered securities dealer activities as measured by gross receipts. Specifically, proposed § 1.59A–2(e)(2)(iii) provides that an aggregate group that includes a bank or a registered securities dealer that is a member of an affiliated group is not treated as including a bank or registered securities dealer for a taxable year if the total gross receipts of the aggregate group attributable to the bank or the registered securities dealer represent less than two percent of the total gross receipts of the aggregate group (or consolidated group if there is no aggregate group). Even if a taxpayer qualifies for the de minimis exception to the lower base erosion percentage test threshold, proposed § 1.59A–5(c)(2) provides that the BEAT rate is increased by an additional one percent for any

taxpayer that is a member of an affiliated group that includes a bank or registered securities dealer. *See* section 59A(b)(3) (requiring that the base erosion and anti-abuse tax rate in effect for the taxable year for these taxpayers must be increased by one percentage point).

A comment requested that the final regulations provide for a higher de minimis threshold of five percent and clarify that in characterizing the income of a corporation with a bank or securities dealer division for purposes of this threshold, only the gross receipts arising from the conduct of the banking or securities business would be taken into account. The Treasury Department and the IRS have determined that this modification to the de minimis threshold is not warranted because this de minimis exception in the proposed regulations was developed based on a qualitative assessment of a very small degree of activities to justify a regulatory-based exception to the statutory provision that applies to a bank or registered securities dealer. Accordingly, the final regulations retain the two-percent de minimis threshold.

Comments supported the proposed regulations' de minimis exception to the lower base erosion percentage threshold and suggested that a similar exception be created regarding the increased BEAT rate for a taxpayer that is a member of an affiliated group with de minimis gross receipts attributable to banking or securities dealer activities. In instances where the base erosion percentage exceeds three percent, the comments questioned the appropriateness of applying the BEAT rate add-on of one percent to the non-financial members of the affiliated group when the gross receipts of the financial members are insignificant relative to the non-financial members.

The final regulations adopt this comment by revising § 1.59A-5(c)(2) to provide that the additional one percent 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.

A comment recommended that an additional exception to the increased BEAT rate should be provided where the bank or securities dealer members of an affiliated group make no more than a de minimis amount of base erosion payments, measured by reference to aggregate affiliated group base erosion payments. The final regulations do not adopt this recommendation because the base erosion percentage test already operates as a statutory rule that limits the BEAT to taxpayers (without regard to any particular type of business) that

have a relatively low degree of base erosion payments.

A comment requested that the final regulations include a transitory ownership exception to apply where a bank or securities dealer is a member of an affiliated group for only a short period (such as 90 days) during the taxable year. The stated purpose of this request was to allow time for a taxpayer that acquires a group that includes a bank or registered securities dealer to dispose of the bank or securities dealer member of a target affiliated group without causing the entire acquiring affiliated group to become subject to the higher BEAT rate applicable to taxpayers with bank or registered securities dealer members. The Treasury Department and the IRS decline to expand the regulatory de minimis exception to include an exception based on short-term ownership, but note that a taxpayer in this situation may be eligible for the de minimis regulatory exception if the bank and securities dealer operations are relatively small. If the operations are not sufficiently small, the statutory rules that apply to banks and registered securities dealers would no longer apply in taxable years after the disposition of the bank or securities dealer.

A comment observed that the rule in the proposed regulations extending the lower base erosion percentage threshold to the entire aggregate group that includes a bank or registered securities dealer is not supported by the language of section 59A. The comment proposed that the proper application of section 59A requires that the lower base erosion percentage should be limited to only the affiliated group that includes a bank or registered securities dealer, and not the remainder of the taxpayer's aggregate group. The final regulations do not adopt this comment. The Treasury Department and the IRS note that section 59A(e)(3) specifically requires aggregation for purposes of computing the base erosion percentage. Further, the implication of the comment is that in measuring whether a particular taxpayer has a base erosion percentage that is greater than the prescribed level in section 59A(e)(3)(C), the threshold level would be blended. That is, under the approach recommended by the comment, a taxpayer with a bank or securities dealer in its aggregate group would compute a relative weighting of the bank/dealers (two percent threshold) vs. non-bank/dealers (three percent threshold) in order to compute a blended threshold that is used for the base erosion percentage test. There is no indication in the statutory language supporting this approach. Accordingly,

no changes are made to the final regulations in this regard.

#### *E. Applicability of Section 15 to the BEAT Rate*

Section 59A(b)(1)(A) provides that the base erosion minimum tax amount of an applicable taxpayer for any taxable year is the excess of an amount equal to 10 percent (5 percent in the case of taxable years beginning in calendar year 2018) of the modified taxable income of the taxpayer for the taxable year. Proposed § 1.59A-5(c) provides the base erosion and anti-abuse tax rates that apply for purposes of calculating the BEMTA. The base erosion and anti-abuse tax rate is five percent for taxable years beginning in calendar year 2018 and 10 percent for taxable years beginning after December 31, 2018, and before January 1, 2026. Proposed § 1.59A-5(c)(1)(i) and (ii). Proposed § 1.59A-5(c)(3) provides that section 15 does not apply to any taxable year that includes January 1, 2018, and further provides that for a taxpayer using a taxable year other than the calendar year, section 15 applies to any taxable year beginning after January 1, 2018. In the case of taxpayers that use a taxable year other than the calendar year and that includes January 1, 2019, this proposed regulation provides that section 15 applies to the change in the section 59A tax rate from 5 percent to 10 percent, based on an effective date of January 1, 2019.

Several comments asserted that final regulations should provide that section 15 applies only to the change in tax rate set forth in section 59A(b)(2) and should not apply to the change in tax rate included in section 59A(b)(1)(A) for taxable years beginning in calendar year 2018. The final regulations adopt this comment. In adopting this comment that section 15 not apply to the change in tax rate included in section 59A(b)(1)(A) for taxable years beginning in calendar year 2018, the final regulations provide no inference as to the application of section 15 to other provisions of the Code that do not set forth an explicit effective date.

### **VII. Comments and Changes to Proposed § 1.59A-6—Qualified Derivative Payments**

Proposed § 1.59A-6 provides guidance regarding QDPs.

#### *A. Scope of the QDP Exception*

Proposed § 1.59A-6(b) defines a QDP as a payment made by a taxpayer to a foreign related party pursuant to a derivative with respect to which the taxpayer (i) recognizes gain or loss as if the derivative were sold for its fair market value on the last business day of

the taxable year (and any additional times as required by the Code or the taxpayer's method of accounting); (ii) treats any recognized gain or loss as ordinary; and (iii) treats the character of all items of income, deduction, gain, or loss with respect to a payment pursuant to the derivative as ordinary. The definition in the proposed regulations adopts the statutory definition of a QDP contained in section 59A(h)(2)(A). The QDP exception under the statute and the proposed regulations is subject to further limitations that are discussed in Parts VII.B and C of this Summary of Comments and Explanation of Revisions.

A comment requested that the scope of the QDP definition be expanded. The comment requested that the final regulations extend the scope of the QDP exception so that multinational corporations that use a centralized hedging center structure can benefit from this exception from the definition of a base erosion payment with respect to their outbound related-party hedging payments. The comment stated that taxpayers in the oil and gas sector often do not adopt a mark-to-market method of tax accounting for a variety of business and tax-related reasons. The comment recommended that the final regulations adopt a distinct QDP exception that would be applicable to oil and gas hedging centers (as well as any similarly situated hedging centers). The comment requested that this QDP exception exclude related-party hedging payments from the scope of base erosion payments, without regard to whether the taxpayer satisfies the requirement in section 59A(h)(2)(A)(i) that the taxpayer accounts for the underlying commodity derivative on a mark-to-market basis. As an alternative, the comment suggested that the final regulations could interpret the mark-to-market requirement of section 59A(h)(2)(A)(i) broadly to cover taxpayers that undertake mark-to-market accounting for derivatives for either financial accounting or tax purposes.

For a derivative payment to qualify for the QDP exception, section 59A(h)(2)(A) requires that the taxpayer recognize gain or loss with respect to the derivative as if the derivative were sold for its fair market value on the last business day of the taxable year, and "such additional times as required by this title or the taxpayer's method of accounting" (emphasis added). The Treasury Department and the IRS, therefore, interpret section 59A as excluding a derivative from the QDP exception if the taxpayer does not adopt a mark-to-market method of tax accounting. In light of the statute's clear requirement for the QDP exception that

a derivative must be treated as sold for its fair market value on the last business day of the taxable year (or more frequently, if required by the Code or the taxpayer's method of accounting), the final regulations do not adopt the comment. See § 1.475(a)–4(d).

#### *B. Sale-Repurchase Transactions and Securities Lending Transactions*

Section 59A(h)(1) provides that a QDP is not treated as a base erosion payment. To qualify for the QDP exception, the payment must be made with respect to a derivative. A derivative is generally defined in section 59A(h)(4) as any contract the value of which, or any payment or other transfer with respect to which, is directly or indirectly determined by reference to one or more listed items, including any share of stock in a corporation or any evidence of indebtedness. A derivative does not include any of the listed items. Section 59A(h)(3) excludes from the QDP exception any payment that would be treated as a base erosion payment if it were not made pursuant to a derivative (for example, interest on a debt instrument). Section 59A(h)(3) also excludes any payment properly allocable to a nonderivative component of a contract that contains derivative and nonderivative components.

The preamble to the proposed regulations notes that a sale-repurchase transaction satisfying certain conditions is treated as a secured loan for U.S. federal tax purposes, and therefore, is not a derivative. REG-104259-18, 83 FR 65962 (December 21, 2018). The preamble to the proposed regulations explains that "[b]ecause sale-repurchase transactions and securities lending transactions are economically similar to each other, the Treasury Department and the IRS have determined that these transactions should be treated similarly for purposes of section 59A(h)(4), and therefore payments on those transactions are not treated as QDPs." REG-104259-18, 83 FR 65963 (December 21, 2018). As a result, proposed § 1.59A-6(d)(2)(iii) provides that a derivative does not include any securities lending transaction, sale-repurchase transaction, or substantially similar transaction.

Comments generally agreed that a sale-repurchase transaction that is treated as a secured loan for U.S. federal income tax purposes is not a derivative; therefore, comments acknowledged that a sale-repurchase transaction that is treated as a secured loan for U.S. federal tax purposes is not eligible for the QDP exception under section 59A, regardless of the specific exclusion language in proposed § 1.59A-6(d)(2)(iii). Certain

comments explained that the nominal seller of the securities in a sale-repurchase transaction is treated as transferring the securities as collateral of a loan. Comments interpret current federal income tax law to provide that the nominal seller remains the tax owner of the securities when a sale-repurchase transaction is treated as a secured loan for federal income tax purposes. Therefore, when the nominal buyer of the securities receives payments with respect to the collateral securities (for example, in the case of an equity security, the dividend payments), and passes those payments on to the nominal seller (or otherwise credits the seller for the amount of the payments), the comments asserted that the nominal seller is treated as having directly received those payments from the issuer of the securities.

In the context of section 59A, if the nominal seller in a sale-repurchase transaction that is treated as a loan is a domestic corporation and the nominal buyer is a foreign related party, any interest paid with respect to the secured loan from the domestic corporation to the foreign related party would be a base erosion payment, not a QDP. In a sale-repurchase transaction that is treated as a loan for which the nominal seller is instead a foreign related party and the nominal buyer is a domestic corporation, the payments with respect to the security held by the nominal buyer as collateral for that transaction are treated as received by the nominal buyer for the benefit of the nominal seller. Because there is no regarded "substitute payment" from the nominal buyer to the nominal seller, there cannot be a base erosion payment.

Comments asserted that securities lending transactions and sale-repurchase transactions are treated differently with respect to underlying payments or substitute payments as a result of proposed § 1.59A-6(d)(2)(iii) even though the transactions are economically similar. Comments observed that in a typical fully-collateralized securities lending transaction, the securities lender transfers the securities to the securities borrower in exchange for an obligation by the borrower to make certain payments to the securities lender and return identical securities. Unlike a sale-repurchase transaction, comments remarked that this transaction results in a transfer of beneficial ownership of the securities to the securities borrower for U.S. federal income tax purposes. Comments noted that these securities lending transactions may arise in the ordinary course of business, for example, to facilitate a short sale of the

underlying security. In connection with the transfer of securities, the securities borrower provides cash or other collateral to the securities lender, typically with the same or greater value as the underlying security. Comments observed that the securities lender in these transactions can be viewed as both a lender of securities to the counterparty, and as the borrower of cash from the counterparty.

Comments suggested that the final regulations should treat a collateralized securities lending transaction as consisting of two legs: (1) A loan of securities, or a “securities leg”, and (2) a loan of cash, or a “cash leg.” Comments stated that the cash leg is simply a cash borrowing by the security lender. Many comments conceded that the cash leg of a securities lending transaction should not be eligible for the QDP exception because the cash leg is properly treated as a loan and any payments should be treated as interest. Certain of these comments observed that the treatment of the cash leg of a securities lending transaction as debt giving rise to interest payments is consistent with the broadly symmetrical treatment of securities lending transactions and sale-repurchase transactions that are treated as secured loans for U.S. federal income tax purposes.

Comments, however, asserted that the securities leg of a securities lending transaction should be treated as a derivative that qualifies for the QDP exception. The comments argued that a securities leg meets the statutory requirement of a derivative because it represents a contract, which includes any short position, the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to any share of stock in a corporation. By treating a substitute payment in a securities lending transaction as eligible for the QDP exception, those payments would receive similar treatment for purposes of section 59A as in the case of a sale-repurchase transaction that is treated as a secured loan. That is, in the sale-repurchase transaction, the remittances on the collateral by the nominal buyer to the nominal seller are treated as a payment from the issuer of the security to the nominal seller for U.S. federal income tax purposes.

Some comments acknowledged that in certain circumstances, there is the potential to use a securities lending transaction as a financing. One comment described a scenario involving an uncollateralized securities borrowing by a domestic corporation of relatively risk-free debt, such as short-term

Treasury bills, from a foreign related party. As a second step, the domestic corporation immediately sells the Treasury bills for cash; after a short period, the taxpayer buys even shorter-term Treasury bills and redelivers them to the lender. Comments acknowledged that in this situation, or in similar situations, the transaction may be viewed as economically equivalent to borrowing money, with the taxpayer exposed to the relatively small risk of changes in the value of the security (here, U.S. government-backed Treasury bills).

Rather than excluding all securities lending transactions from QDP status, comments generally recommended that the final regulations adopt rules to address this particular risk. Some comments recommended adopting a specific operating rule to address this concern, including (i) providing that only contracts entered into in the ordinary course of the taxpayer's trade or business can qualify for the QDP exception, (ii) providing that only fully collateralized transactions can qualify for the QDP exception, or (iii) applying different rules for securities lending transactions involving relatively low-risk securities (such as Treasury bills) than for other securities that are subject to more market risk. Regarding fully collateralized securities lending transactions, some comments asserted that under certain bank regulatory regimes, other amounts outside of the actual collateral in the transaction may effectively serve as collateral due to the securities borrower's compliance with any specific regulatory regime governing securities borrowing. Some comments recommended that the final regulations adopt an anti-abuse rule rather than an operating rule to address this concern. One comment suggested an anti-abuse rule that excludes from the QDP exception transactions with specific debt-like features that make the transaction substantially similar to a financing, while another comment noted that it would be unduly burdensome to test contracts based on certain characteristics, particularly for taxpayers that engage in a high volume of these transactions in the ordinary course. This comment instead suggested that all securities lending transactions entered into for valid non-tax business purposes should be eligible for the QDP exception.

In response to these comments, the final regulations make certain revisions to § 1.59A–6(d)(2)(iii). First, § 1.59A–6(d)(2)(iii) has been revised to more directly provide that a derivative contract as defined in section 59A(h)(4) does not include a sale-repurchase

transaction or substantially similar transaction that is treated as a secured loan for U.S. federal income tax purposes. Second, § 1.59A–6(d)(2)(iii) is also revised to exclude from the definition of a derivative for purposes of section 59A(h) the cash leg of a securities lending transaction, along with cash payments pursuant to a sale-repurchase transaction, or other similar transaction. The final regulations no longer expressly exclude securities lending transactions from the definition of a derivative contract in § 1.59A–6(d)(2)(iii). As a result, payments (such as a borrow fee) made with respect to the securities leg of a securities lending transaction may qualify as a QDP.

To address the concern about securities lending transactions that have a significant financing component, the final regulations adopt the recommendation from comments to provide an anti-abuse rule. *See* § 1.59A–6(d)(2)(iii)(C). The anti-abuse rule in the final regulations includes criteria to limit the rule to situations that have been identified as presenting clear opportunities for abuse. The anti-abuse rule takes into account two factors: (a) Whether the securities lending transaction or substantially similar transaction provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing and (b) whether the transaction is part of an arrangement that has been entered into with a principal purpose of avoiding the treatment of any payment with respect to the transaction as a base erosion payment. The determination of whether a securities lending transaction or substantially similar transaction provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing takes into account arrangements that effectively serve as collateral due to the taxpayer's compliance with any U.S. regulatory requirements governing such transaction. The anti-abuse rule is based on these factors because the Treasury Department and the IRS are cognizant that an objective mechanical rule based on the level of collateralization may be difficult for both taxpayers and the IRS to apply, in particular due to the high volume of transactions issued under varying conditions.

### C. QDP Reporting Requirements

Section 59A(h)(2)(B) provides that no payment is a QDP for a taxable year “unless the taxpayer includes in the information required to be reported under section 6038B(b)(2) <sup>4</sup> [sic] with

<sup>4</sup> As enacted, section 59A(h)(2)(B) cross-references section 6038B(b)(2). This cross-reference



respect to such taxable year such information as is necessary to identify the payments to be so treated and such other information as the Secretary determines necessary to carry out the provisions of this subsection.” Proposed § 1.59A–6(b)(2)(i) clarifies that no payment is a QDP unless the taxpayer reports the information required by the Secretary in proposed § 1.6038A–2(b)(7)(ix). Proposed § 1.6038A–2(b)(7)(ix) identifies the specific information that a taxpayer needs to report to comply with the reporting requirement of section 59A(h)(2)(B) and proposed § 1.59A–6(b)(2)(i). The proposed regulations provide that the rule for reporting QDPs applies to taxable years beginning one year after final regulations are published in the **Federal Register**. Proposed § 1.6038A–2(g). Before proposed § 1.6038A–2(b)(7)(ix) is applicable, a taxpayer is treated as complying with the QDP reporting requirement by reporting the aggregate amount of QDPs on Form 8991. *Id.*

### 1. Scope of QDP Reporting

Section 1.6038A–1(c) generally defines a reporting corporation as either a domestic corporation that is 25-percent foreign-owned, or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. A comment recommended that the final regulations clarify that a failure to comply with the Form 8991 reporting requirements by a taxpayer that is not a reporting corporation (within the meaning of § 1.6038A–1(c)) does not affect the QDP status of any payments made by the taxpayer. The comment also recommended that the final regulations clarify the consequences of failing to comply with the Form 8991 QDP reporting requirements.

Section 59A(h)(2)(B) requires that all taxpayers, whether or not the taxpayer is a reporting corporation within the meaning of section 6038A, report QDPs in order for the exception to apply to any particular payment. The Treasury Department and the IRS interpret the language in section 59A(h)(2)(B) referencing section 6038B(b)(2) (“the information required to be reported under section 6038B(b)(2) [sic]”) as addressing the scope of information required to be reported rather than limiting the scope of taxpayers that must report in order to qualify

derivatives as QDPs under section 59A(h). The final regulations, therefore, clarify that § 1.59A–6(b)(2)(i) applies to all taxpayers (whether or not a taxpayer is a reporting corporation as defined in § 1.6038A–1(c)) and that all taxpayers must report the information required by § 1.6038A–2(b)(7)(ix) for a payment to be eligible for QDP status.

Comments also requested additional guidance regarding the consequences when a taxpayer fails to comply with the QDP reporting requirements with respect to a particular payment. The proposed regulations provide that a failure by a taxpayer to report a particular payment as a QDP disqualifies only that payment and does not affect the taxpayer’s properly reported payments. The final regulations retain that rule. In addition, § 1.59A–6(b)(2)(i) provides that a taxpayer satisfies the reporting requirement by including a QDP in the aggregate amount of all QDPs (rather than the aggregate amount as determined by type of derivative contract as provided in proposed § 1.6038A–2(b)(7)(ix)(A)) on Form 8991 or a successor form.

Another comment requested a reasonable cause exception to the QDP reporting requirements because treating a payment as a base erosion payment solely when a taxpayer failed to report the payments as a QDP would unfairly penalize a taxpayer for making an error. The Treasury Department and the IRS have determined that a reasonable cause exception is inappropriate because section 59A(h)(2)(B) provides that a taxpayer must identify all base erosion payments. A taxpayer must determine that a payment is eligible for the QDP exception and, therefore, properly excluded from the base erosion percentage calculation. Similarly, a taxpayer must determine that a payment is properly characterized as a QDP to properly determine modified taxable income for purposes of section 59A. In addition, a reasonable cause exception would make it more difficult for the IRS to administer section 59A. However, as discussed in Part VII.C.3 of this Summary of Comments and Explanation of Revisions, the final regulations provide a good faith standard that applies during the QDP transition period before the reporting set forth in § 1.6038A–2(b)(7)(ix) is required. In addition, in response to comments, the transition period has been extended to 18 months.

### 2. Determining the Amount of QDP Payment

A comment recommended that the final regulations clarify that taxpayers

may use the net amount with respect to each derivative transaction to arrive at the aggregate QDP amount that must be reported on Form 8991. The comment noted that this approach would be consistent with the BEAT Netting Rule for mark-to-market transactions. See Part III.D of Summary of Comments and Explanation of Revisions. Generally, the Treasury Department and the IRS have adopted this comment. See § 1.59A–6(b)(2)(iii). A taxpayer, however, must exclude from the net amount of a QDP any payment made with respect to a derivative that is either excluded from QDP status pursuant to section 59A(h)(3) or otherwise treated as a type of payment that is not a derivative payment. See § 1.59A–6(b)(3)(ii).

Another comment requested excluding from QDP reporting requirements any payments with respect to securities lending transactions and sale-repurchase transactions that are not regarded under generally accepted accounting principles (GAAP). The final regulations do not adopt this recommendation. Reporting QDPs is a statutory requirement to provide the IRS with data about transactions that have been excluded under the QDP exception, and the financial accounting for these transactions is not relevant to QDP status. Furthermore, the Treasury Department and the IRS have determined that the deferred applicability date and transition period, described in Part VII.C.3 of Summary of Comments and Explanation of Revisions, will provide taxpayers with adequate time to develop systems to track the information that may not have been previously maintained in accounting systems.

### 3. Applicability Date and Transition Period for QDP Reporting

Comments asserted that taxpayers needed additional time before the final regulations regarding QDP reporting are applicable. Comments noted that before the enactment of section 59A, taxpayers generally were not required to separately track or account for certain transactions with foreign related parties. The Treasury Department and the IRS recognize that section 59A will require taxpayers to develop new systems to properly report QDPs; therefore, the final regulations extend the transition period for meeting the complete QDP reporting requirements until taxable years beginning Monday, June 7, 2021.

Another comment requested additional guidance regarding the QDP reporting requirements that apply before the applicability date of the final regulations for these rules (the “QDP transition period”). Specifically,

<sup>1</sup> in section 59A(h)(2)(B) is a typographical error. Section 6038B(b)(2) does not relate to section 59A. The correct cross-reference is to section 6038A(b)(2). The Act added reporting requirements for section 59A in section 6038A(b)(2). See Act, § 14401(b).

comments interpreted the QDP transition period as applying only to a reporting corporation as defined in § 1.6038A-1(c). They recommended that all taxpayers be permitted to report QDPs on an aggregate basis during the QDP transition period and that the good faith effort standard for reporting QDPs during the transition period should apply to all taxpayers. The final regulations adopt these comments by clarifying that § 1.6038A-2(b)(7)(ix) applies to a taxpayer whether or not the taxpayer is a reporting corporation as defined in § 6038A-1(c). See § 1.59A-6(b)(2)(i). In addition, the final regulations eliminate the rule in the proposed regulations requiring a taxpayer to report the aggregate amount of QDPs as determined by type of derivative contract, the identity of each counterparty, and the aggregate amount of QDPs made to each counterparty. The Treasury Department and the IRS anticipate that the aggregate amount of QDPs provides adequate information to allow the IRS to administer the QDP rules.

#### **VIII. Comments and Changes to Proposed § 1.59A-7—Application of BEAT to Partnerships**

Proposed § 1.59A-7 provides rules regarding how partnerships and their partners are treated for purposes of the BEAT. The proposed regulations generally apply an aggregate approach in addressing the treatment of payments made by a partnership or received by a partnership for purposes of section 59A.

##### *A. Partnership Contributions and Distributions*

###### **1. Request for Contribution Exception**

The proposed regulations treat a contribution to a partnership as a transaction between the partners that may result in a base erosion payment, including when a partnership with a domestic corporate partner receives a contribution of depreciable property from a foreign related party. Several comments requested a change to the approach taken in the proposed regulations. One comment asserted that the issuance of a partnership interest in exchange for a contribution to a partnership was not intended to be a base erosion payment covered by section 59A(d)(2) and that subjecting inbound nonrecognition transactions to the BEAT seems contrary to the purpose of the Act, which the comment stated was to encourage taxpayers to relocate business functions and assets to the United States and expand business activities in the United States. The comment noted that if Congress

intended to subject nonrecognition transactions to the BEAT, it would have done so more explicitly.

Other comments generally asserted that nonrecognition transactions should not be subject to the BEAT. Some of these comments specifically addressed section 721 transactions and recommended that the same exception for section 351 transactions that is discussed in Part IV.B.3 of this Summary of Comments and Explanation of Revisions apply to section 721(a) transactions.

In contrast, a comment noted that applying an aggregate approach to partnerships for purposes of the BEAT was consistent with the purposes of the statute. The comment asserted that treating a contribution of property in exchange for a partnership interest as a potential base erosion payment is consistent with the concept of treating a partnership as an aggregate of its partners and with the purposes of section 59A. The comment explained that to the extent there is a base eroding transaction when property (such as depreciable property) is contributed to a partnership under section 721, it is the acquisition of a proportionate share of new property by the existing partners from a contributing partner (assuming that partner is a foreign related party). The comment also explained that the existing partners would have paid for the new property with a proportionate share of the existing assets of the partnership. In addition, the comment noted that a contributing partner (such as a domestic corporation) could be acquiring a proportionate share of the partnership's existing assets (where one or more partners of the partnership are foreign related parties).

The final regulations do not adopt the comments requesting an exception for nonrecognition transactions involving partnerships. The general premise of the aggregate approach to transactions involving partners and partnerships in both the proposed regulations and the final regulations is to treat partners as engaging in transactions directly with each other, not as engaging in transactions with the partnership as a separate entity (solely for purposes of section 59A). See § 1.59A-7(b) and (c); proposed § 1.59A-7(b)(1)–(3); REG-104259-18, 83 FR 65965 (December 21, 2018). The Treasury Department and the IRS acknowledge that the final regulations include an exception for specified corporate nonrecognition transactions that is discussed in Part IV.B.3 of the Summary of Comments and Explanation of Revisions, which presents some similarity with the types of transactions contemplated by this

comment. For example, if a domestic corporation and a foreign related party each contribute depreciable property to a new domestic corporation in exchange for stock of the new domestic corporation in a transaction that qualifies under section 351(a), the new domestic corporation generally will not be treated as making a base erosion payment in exchange for the depreciable property pursuant to the new exception in the final regulations for specified corporate nonrecognition transactions that is discussed in Part IV.B.3 of the Summary of Comments and Explanation of Revisions. In contrast, if the same domestic corporation and a foreign related party each contribute depreciable property to a new partnership in exchange for interests in the partnership in a transaction that qualifies under section 721(a), the transaction is treated as a partner-to-partner exchange that may result in a base erosion payment solely for purposes of section 59A, with no specific exception adopted in the final regulations.

The final regulations do not extend the exception for specified corporate nonrecognition transactions to partnership transactions because that treatment would be generally inconsistent with the approach of treating partners in a partnership as engaging in transactions with each other. The preamble to the proposed regulations states that the Treasury Department and the IRS determined that a rule that applies the aggregate principle consistently is necessary to align the treatment of economically similar transactions. REG-104259-18, 83 FR 65956, 65967 (Dec. 21, 2018).

The adoption of a section 721(a) exception to the BEAT could permit related parties to use a partnership to avoid a transaction that would be a base erosion payment if that transaction occurred directly among the partners. The Treasury Department and the IRS acknowledge that in some respects, a similar argument could be made against adopting the exception for specified corporate nonrecognition transactions that applies to the section 351(a) example that is described in this Part VIII.A.1; however, the general tax rules that apply to corporations under subchapter C are fundamentally different from the general tax rules that apply to partnerships under subchapter K. In particular, when property is distributed by a partnership back to the partner, nonrecognition by the partnership and the partner is the general rule under subchapter K; however, when property is distributed by a corporation back to its shareholder,

recognition and income by the corporation and the shareholder is the general rule under subchapter C. Compare sections 731(b) and (a) with sections 311(b) and 301(c). For these reasons, the final regulations do not extend the exception that is provided to specified corporate nonrecognition transactions to partnership nonrecognition transactions, such as contributions.

## 2. Amounts Paid or Accrued

Proposed § 1.59A–3(b)(2)(i) confirms that an amount “paid or accrued,” as those terms are used for purposes of determining whether there is a base erosion payment, includes an amount paid or accrued using any form of consideration.

A comment asserted that subchapter K of the Code contains well-developed provisions to distinguish between a sale or exchange, as opposed to a contribution, and that there should only be a “payment or accrual” for purposes of section 59A(d) to the extent a partner is treated as receiving proceeds from the partnership pursuant to a sale (for example, under the disguised sale rules of section 707). Similarly, a comment recommended that a distribution by a partnership described in section 731 generally not be treated as an amount paid or accrued for purposes of section 59A, except to the extent that the transaction would be treated as a deemed sale of property by the partnership.

In addition, one comment recommended that if the final regulations continue to treat certain partnership contributions and distributions as “payments” that could be base erosion payments, the applicability date of the provisions relating to this treatment should be modified to take into account that taxpayers have engaged in contributions to (or distributions by) partnerships between December 31, 2017, and December 21, 2018, without guidance that these transactions could be treated as base erosion payments. The comment also recommended a special rule to exclude pro-rata contributions (contributions made by each partner of the partnership in proportion to its interest in the partnership) from the definition of “an amount paid or accrued.”

The final regulations continue to treat contributions to and distributions from partnerships as “payments” that could be base erosion payments under the aggregate approach. Section 59A does not contain an explicit restriction on the type of consideration that constitutes a payment. Proposed § 1.59A–3(b)(2)(i)

confirms that “an amount paid or accrued includes an amount paid or accrued using any form of consideration, including cash, property, stock, or the assumption of a liability.” The final regulations include the same language. The Treasury Department and the IRS have determined that it is not appropriate to change the operating rule describing payment consideration or delay its application. However, in response to comments, the final regulations add partnership interests to the non-exclusive list of examples of consideration in § 1.59A–3(b)(2)(ii) to reaffirm this result.

The final regulations do not exclude pro-rata contributions from the definition of “an amount paid or accrued” and therefore, they are not excluded from the definition of a base erosion payment. If pro-rata contributions are made by each partner, each transaction must be separately considered, consistent with the general rule in section 59A that assesses transactions on a gross, rather than net, basis. A pro-rata contribution exclusion would be inconsistent with the aggregate approach taken in these final regulations. For example, if there was an exception, a domestic corporation could contribute cash to a new partnership and its foreign parent could contribute depreciable property, each in proportion to their interest in the partnership, and under the exception, the transaction would not be subject to section 59A even though, under the aggregate approach, the domestic corporation effectively acquired its proportionate share of the contributed depreciable property from a foreign related party in exchange for cash. *See also* Part VIII.B of this Summary of Comments and Explanation of Revisions (Netting). To clarify this point, § 1.59A–7(c)(5)(iv) provides that when both parties to a transaction use non-cash consideration, each party must separately determine its base erosion payment with respect to each property, and § 1.59A–7(d)(1) provides that base erosion tax benefits are calculated separately for each payment or accrual on a property-by-property basis and are not netted.

Consistent with the approach taken for contributions to a partnership, the Treasury Department and the IRS determined that no special rule should be provided for distributions by a partnership. The approach suggested by a comment—only treating distributions subject to the disguised sales rules as potential base erosion payments—would be inconsistent with the aggregate approach to partnerships for the reasons discussed in the context of partnership contributions.

## 3. Request for ECI Exception

A comment recommended 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 effectively connected income. The final regulations do not include rules relating to these comments. In the 2019 proposed regulations, however, the Treasury Department and the IRS request comments regarding how to address 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. *See* Part VI.B of the Explanation of Provisions of the preamble to the 2019 proposed regulations in which the Treasury Department and the IRS request comments regarding transactions involving partners and partnerships that have effectively connected income.

### B. Netting

Proposed § 1.59A–3(b)(2)(iii) provides that the amount of any base erosion payment is determined on a gross basis unless the transaction is subject to a special mark-to-market rule or the Code or regulations otherwise provide. A comment requested that a special netting rule be provided for partnerships when the base erosion tax benefits allocated by a partnership are reduced by deductions foregone as a result of the partner contributing property to the partnership.

The Treasury Department and the IRS have determined that this suggestion is inconsistent with the gross basis regime generally. *See* Part IV.A.3 of this Summary of Comments and Explanation of Revisions (Netting). The result addressed in the comment is the same result that would arise if the transactions had occurred outside of a partnership. For example, a taxpayer that acquired one depreciable asset from a foreign related party and sold another asset would be in a similar position: the taxpayer would treat the depreciation with respect to the acquired asset as a base erosion tax benefit and there would

be no offset for deductions from the asset the taxpayer sold (even if those “foregone” deductions would not have been base erosion tax benefits). Section 1.59A–7(d)(1) clarifies that base erosion tax benefits are determined separately for each asset, payment, or accrual, as applicable, and are not netted with other items.

#### *C. Aggregate Approach to Ownership of Partnership Assets*

Proposed § 1.59A–7(b)(5)(i) provides that (subject to the small partner exception), for purposes of section 59A, each partner is treated as owning its share of the partnership items determined under section 704, including the assets of the partnership, using a reasonable method with respect to the assets. A comment proposed either removing the phrase “including the assets of the partnership” from this rule or including examples that clarify the purposes of section 59A for which the aggregate approach to the ownership of partnership assets is relevant.

In response to this comment, the final regulations remove this language from § 1.59A–7(b)(5)(i). Instead, when it is necessary for a person to determine what assets were transferred from or to a partner in a partnership, the relevant provision refers to the partner’s proportionate share of the assets, as determined based on all of the facts and circumstances. *See* § 1.59A–7(c)(2), (3), and (4).

#### *D. Determining the Base Erosion Payment*

Proposed § 1.59A–7(b) generally provides that section 59A is applied at the partner level and that amounts paid or accrued by (or to) a partnership are treated as paid or accrued by (or to) the partners based on their distributive shares.

A number of comments requested clarification with respect to the aggregate approach taken in the proposed regulations. For example, a comment indicated that the proposed regulations do not address how to determine each partner’s share of a payment received by a partnership if the payment results in no income or gain or results in a deduction or loss (for example, where a partnership sells depreciable or amortizable property to an applicable taxpayer and the amount realized is equal to or less than the partnership’s adjusted basis in the property). The comment recommended that the final regulations provide rules for determining the extent to which a partner is treated as receiving a payment received by a partnership where the payment results in no income or a

deduction or loss. The comment suggested that taxpayers be permitted to use a reasonable method to determine each partner’s share of a payment received by the partnership if the payment results in no income and that, in circumstances where a payment results in a deduction or loss, the partner’s share of the payment be determined by the partner’s share of the deduction or loss. Additionally, the comment suggested that the final regulations permit taxpayers to use a reasonable method to determine each partner’s share of the payment received by the partnership where the income or gain is recognized over multiple taxable years (such as in an installment sale).

Comments also requested that the final regulations clarify that depreciation deductions allocated to a taxpayer by a partnership that are attributable to property contributed to the partnership by a foreign related party are not treated as base erosion tax benefits if the property was contributed before the effective date of the BEAT.

One comment requested clarification regarding a scenario described in the preamble in which a foreign related party and a taxpayer form a partnership, and the foreign related party contributes depreciable property to the partnership. The preamble concludes that deductions for depreciation of the property contributed generally are base erosion tax benefits because the partnership is treated as acquiring the property in exchange for an interest in the partnership under section 721(a). REG–104259–18, 83 FR 65956, 65967 (Dec. 21, 2018). The comment requested that the final regulations clarify whether, in the scenario described in the preamble, each partner is treated as making its share of the payment (in the form of an interest in the partnership) to the foreign related party contributing the depreciable property under proposed § 1.59A–7(b)(2) in determining if there is a base erosion payment. The language in the preamble to the proposed regulations that the comment discussed was in error. Consistent with the aggregate approach, the language should have stated that the deductions for depreciation of the property contributed generally are base erosion tax benefits because the *other partners* are treated as acquiring the property in exchange for a portion of their interest in the partnership assets, and this is clarified in the final regulations. *See* § 1.59A–7(c)(3).

In response to the comments, the final regulations provide a more detailed explanation of how the aggregate approach set forth in the proposed regulations operates, including the

treatment of partnership contributions and transfers of partnership interests (including issuances). In addition, § 1.59A–7(g) includes examples illustrating the application of the rules.

The final regulations clarify that if property described in § 1.59A–3(b)(1)(ii) or (iv) (depreciable or amortizable property or property that results in reductions to determine gross income) is transferred to a partnership, each partner is treated as receiving its proportionate share of the property for purposes of determining if it has a base erosion payment. Similarly, if the partnership transfers property described in § 1.59A–3(b)(1)(ii) or (iv), each partner is treated as transferring its proportionate share of the property for purposes of determining if the recipient has a base erosion payment. *See* § 1.59A–7(c)(2). If a partnership interest is transferred (other than by a partnership), the transferor generally is treated as transferring its proportionate share of the partnership’s assets. When a partnership interest is transferred by a partnership, each partner whose proportionate share of assets is reduced is treated as transferring the amount of the reduction. *See* § 1.59A–7(c)(3).

In keeping with this construct, if a taxpayer was a partner in a partnership and a foreign related party contributed depreciable property to the partnership before January 1, 2018, there would be no base erosion payment. However, also consistent with this construct, if a taxpayer acquires an interest (including an increased interest) in any partnership asset (including pursuant to a transfer of a partnership interest either by the partnership or by another person) on or after January 1, 2018, from a partnership that holds depreciable property and has a foreign related party as a partner whose interest in the asset is reduced, with or without a section 754 election by the partnership, that transaction will be a base erosion payment because the property will be treated as acquired on or after January 1, 2018. *See* § 1.59A–7(c).

The final regulations also clarify that the amount of deduction resulting from a payment is not impacted by the gain or loss arising from the consideration used to make the payment. Therefore, if the partnership makes a payment, that payment from the partnership may result in a deduction even if the partnership incurs a gain on the transfer under general tax principles because the partnership used built-in gain property as consideration. Similarly, if the partnership receives a payment as consideration for the sale of built-in loss property, that payment to the partnership will result in income. *See*

§ 1.59A–3(b)(2)(ix) and § 1.59A–7(c)(5)(iv) and (d)(1).

If a series of payments or accruals with respect to a transaction occurs over time, whether there is a base erosion payment is determined each time there is a payment or accrual. If, instead, there is a single payment that results in base erosion tax benefits being allocated by a partnership over multiple years, the portion of the payment that is a base erosion payment must be determined at the time of the payment, but the amount of the base erosion tax benefits will be determined based on the allocations by the partnership that occur each year. For example, if a partnership, whose partners are a domestic corporation and an unrelated person, acquires depreciable property from a foreign related party of the domestic corporation, then the entire amount is a base erosion payment with respect to the domestic corporation and any allocations by the partnership of depreciation to the domestic corporation are base erosion tax benefits.

The final regulations clarify that if a distribution of property from a partnership to a partner causes an increase in the tax basis of property that either continues to be held by the partnership or is distributed from the partnership to a partner, such as under section 732(b) or 734(b), the increase in tax basis for the benefit of a taxpayer that is attributable to a foreign related party is treated as if it was newly purchased property by the taxpayer from the foreign related party that is placed in service when the distribution occurs for purposes of determining if a taxpayer has a base erosion payment. *See* § 1.59A–7(c)(4).

The final regulations also include certain additional operating rules to clarify how § 1.59A–7 applies. For example, § 1.59A–7(c)(5)(ii) clarifies the order in which the base erosion payment rules apply, and § 1.59A–7(c)(5)(iv) reaffirms that if both parties to a transaction use non-cash consideration, each transfer of property must be separately analyzed to determine if there is a base erosion payment.

The final regulations also clarify that if a transaction is not specifically described in § 1.59A–7, whether it gives rise to a base erosion payment or base erosion tax benefit will be determined in accordance with the principles of § 1.59A–7 and the purposes of section 59A. *See* § 1.59A–7(b). Further, the final regulations clarify that the aggregate approach under § 1.59A–7 does not override the treatment of any partnership item under any Code

section other than section 59A. *See* § 1.59A–7(a). That clarification is consistent with the principle that a rule of general applicability applies unless explicitly replaced or turned off by another rule. Thus, for example, section 482 continues to apply to controlled transactions involving partnerships (such as transfers of property or provisions of services, contributions, and distributions), as it applies to all controlled transactions, and is taken into account in determining the arm's length consideration for such transactions (such as the pricing of transferred property or services, and the valuation of contributions and distributions) and in determining whether partnership transactions (including partnership allocations) otherwise clearly reflect income. *See*, for example, §§ 1.482–1(f)(1)(iii) and (i)(7) and (8) and 1.704–1(b)(1)(iii) and (5)(Ex. 28); Notice 2015–54, 2015–34 I.R.B. 210, §§ 2.03 and 2.04.

Given the absence in the statute of a provision describing the specific treatment of partnerships and partners, the Act's legislative history, and the overall significance of the proper functioning of the BEAT regime, the Treasury Department and the IRS have determined that, in addition to section 59A, certain authorities in subchapter K provide support for the treatment of partners and partnerships under these final regulations. The 1954 legislative history to subchapter K makes clear that this determination of aggregate versus entity should be based on the policies of the provision at issue, in this case, section 59A. *See* H.R. Rep. No. 83–2543, at 59 (1954). Under the rules of subchapter K, an aggregate approach applies if it is appropriate to carry out the purpose of a provision of the Code, unless an entity approach is specifically prescribed and clearly contemplated by the relevant statute. *See*, for example, § 1.701–2(e). The BEAT regime does not prescribe the treatment of a partnership as an entity and the treatment of a partnership as an aggregate is appropriate with respect to payments made to or received by it.

#### *E. Determining a Partner's Base Erosion Tax Benefit*

For purposes of determining whether a payment or accrual by a partnership is a base erosion payment, proposed § 1.59A–7(b)(2) provides that (subject to the small partner exception) any amount paid or accrued by a partnership is treated as paid or accrued by each partner based on the partner's distributive share of items of deduction (or other amounts that could be base erosion tax benefits) with respect to that

amount (as determined under section 704). A comment noted that proposed § 1.59A–7(b)(2) does not indicate how a partner's base erosion tax benefits would be determined if a partner's distributive share of the partnership item that produces the base erosion tax benefits changed from one taxable year to another taxable year. The comment concluded that the amount of a partner's distributive share of deductions with respect to property acquired by the partner's base erosion payment that is treated as a base erosion tax benefit may not correspond to the amount of the partner's initial base erosion payment with respect to that property. The comment recommended that the final regulations clarify whether any amount of the partner's distributive share of deductions with respect to property acquired by a base erosion payment (in any amount) that is treated as made by the partner would be a base erosion tax benefit, subject to the small partner exception.

Another comment requested that the final regulations provide that when depreciable property is contributed to a partnership that adopts the remedial method under § 1.704–3(d) with respect to that property, the remedial items of depreciation (which may be allocated to a partner that is an applicable taxpayer) should not be treated as base erosion tax benefits. The comment further asserted that treating remedial items as base erosion tax benefits would penalize applicable taxpayers that are U.S. transferors in section 721(c) partnerships for which the gain deferral method is applied. *See generally* § 1.721(c)–1T.

As recommended by a comment, § 1.59A–7(d)(1) clarifies that the base erosion tax benefits are not dependent on the amount of the base erosion payment, and provides that a partner's base erosion tax benefits are the partner's distributive share of any deductions described in § 1.59A–3(c)(1)(i) or (ii) or reductions to determine gross income described in § 1.59A–3(c)(1)(iii) or (iv) attributable to the base erosion payment.

The final regulations also clarify that a taxpayer's base erosion tax benefits resulting from a base erosion payment include the partner's distributive share of any deduction or reduction to determine gross income attributable to the base erosion payment, including as a result of section 704(c), section 734(b), section 743(b) or certain other sections. *See* § 1.59A–7(d)(1). As a result, if a taxpayer is allocated depreciation or amortization deductions from property acquired pursuant to a base erosion payment, those deductions are base

erosion tax benefits. If the partner obtains depreciation deductions in excess of the partner's proportionate share of the depreciable property, those deductions still arise from the acquisition of the property pursuant to a base erosion payment, and the Treasury Department and the IRS have determined that it would not be appropriate to exclude those deductions from base erosion tax benefit treatment.

#### *F. Small Partner Exception*

The proposed regulations provide that partners with certain small ownership interests are excluded from the aggregate approach for purposes of determining base erosion tax benefits from the partnership. This small partner exception generally applies to partnership interests that: (i) Represent less than ten percent of the capital and profits of the partnership; (ii) represent less than ten percent of each item of income, gain, loss, deduction, and credit; and (iii) have a fair market value of less than \$25 million.

Comments recommended expanding the thresholds for the small partner exception for partnership interests and items to 25 percent, and eliminating the fair market value limitation. The comments suggested that the compliance burden associated with the thresholds in the proposed regulations would be substantial and that minority partners may have little or no ability to obtain the necessary information from the partnership.

The final regulations do not adopt these recommendations. In determining the appropriate threshold for a small ownership interest in the proposed regulations, the Treasury Department and the IRS considered the treatment of small ownership interests in partnerships in analogous situations in other Treasury regulations. Further, the fair market value threshold addresses a concern that while a partner may have a relatively small interest in a partnership, the partnership itself could have significant value such that partnership items should not be excluded from the BEAT base when an analogous payment made outside of the partnership context is not similarly excluded from the BEAT base. The \$25 million fair market value threshold was developed after qualitative consideration of these factors.

Comments also recommended that the small partner exception apply to payments made to a partnership. The final regulations do not adopt this recommendation. The proposed regulations included the small partner interest exception for payments by a partnership in part because the Treasury

Department and the IRS were cognizant that small partners in a partnership may not always have sufficient information about the amounts of payments made by the partnership and the identity of the payee. The Treasury Department and the IRS were also cognizant that this type of information is not currently reportable by the partnership to its partners on a Form K-1; that is, without information provided by the partnership to the taxpayer partner, that partner may not be able to determine whether it is treated as having made a base erosion payment through the partnership pursuant to proposed § 1.59A-7. The Treasury Department and the IRS considered these factors, and reached a qualitative conclusion that at or below the threshold level set forth in the proposed regulations, the administrability considerations outweighed the competing consideration of ensuring that base erosion payments through a partnership are properly taken into account by taxpayer partners in the partnership.

In a situation where a taxpayer makes a payment to a partnership (that is, a payment that may be a base erosion payment under proposed § 1.59A-7 because a partner in the partnership is a foreign related party with respect to the payor), the administrability concerns that factored into the small partner exception for payments by a partnership are less pronounced. That is, the taxpayer (payor) will generally have information to determine whether it has made a payment to a partnership in which any foreign related party is a partner without needing to obtain significant information from the partnership. Based on these factors, the Treasury Department and the IRS reached a qualitative conclusion that the administrability aspects of accounting for payments by a taxpayer to a partnership are not outweighed by the competing consideration of ensuring that base erosion payments to a partnership are properly taken into account by taxpayer payors.

#### **IX. Comments and Changes to Proposed § 1.59A-9—Anti-Abuse and Recharacterization Rules**

Proposed § 1.59A-9 contains anti-abuse rules that recharacterize certain transactions in accordance with their substance for purposes of carrying out the provisions of section 59A. The proposed anti-abuse rules address the following types of transactions: (a) Transactions involving intermediaries acting as a conduit if there is a principal purpose of avoiding a base erosion payment (or reducing the amount of a base erosion payment); (b) transactions

with a principal purpose of increasing the deductions taken into account in the denominator of the base erosion percentage; and (c) transactions among related parties entered into with a principal purpose of avoiding the application of rules applicable to banks and registered securities dealers (for example, causing a bank or registered securities dealer to disaffiliate from an affiliated group so as to avoid the requirement that it be a member of such a group).

Comments generally requested more guidance on when a transaction has “a principal purpose” of avoiding a provision of section 59A. Comments expressed a concern that any transaction that would result in a lower BEAT liability could be viewed as having “a principal purpose” of avoiding a provision of the section 59A regulations. Comments also expressed a concern that the anti-abuse rules could be interpreted as applying to transactions undertaken in the ordinary course of a taxpayer's business. One comment requested that the Treasury Department and the IRS consider whether existing anti-abuse rules and judicial doctrines, including section 7701(o), are sufficient to address abuse of section 59A.

Consistent with the grant of authority in section 59A(i), the Treasury Department and the IRS believe that anti-abuse rules specific to section 59A are needed. The final regulations address the requests for clarity regarding the “principal purpose” standard in the final regulations by adding new examples that illustrate the differences between transactions that the Treasury Department and the IRS find to be abusive or non-abusive. *See* § 1.59A-9(c)(5), (7), (8), (9).

A comment requested that the anti-abuse rule for transactions involving intermediaries acting as a conduit be modified so that it would not apply to transactions where taxpayers restructure their operations in a way that reduces their base erosion payments because they have moved operations to the United States. The comment asserted that proposed § 1.59A-9(b)(1) should not apply where taxpayers restructure their operations for business reasons even if, under the resulting structure, payments are made to a foreign related party through an intermediary. As an example, the comment suggested that taxpayers might restructure their business so that a domestic related party performs functions previously performed by a foreign related party. However, if the foreign related party continues to perform some functions that benefit the taxpayer, and payments for those functions are made through the

domestic related party, the comment suggested that proposed § 1.59A–9(b)(1) could apply to the transaction. The determination of whether proposed § 1.59A–9(b)(1) will apply to a transaction is dependent, in part, on whether the transaction has a principal purpose of avoiding a base erosion payment or reducing the amount of a base erosion payment. The requested exception could lead to inappropriate results where the change in the taxpayer's operations is insignificant compared to the impact of reducing the taxpayer's base erosion payments. Accordingly, the final regulations do not include the requested exception.

Another comment requested clarification on when the anti-abuse rule in proposed § 1.59A–9(b)(1) could apply to a “corresponding payment” to an intermediary that would have been a base erosion payment if made to a foreign related party. The final regulations do not modify this rule because the rule is already clear that it applies to a corresponding payment that is part of a transaction, plan, or arrangement that has a principal purpose of avoiding a base erosion payment, and the final regulations include examples of transactions with such a purpose. Another similar comment requested clarification on when the anti-abuse rule in proposed § 1.59A–9(b)(1) could apply to an “indirect” corresponding payment. The final regulations do not modify this rule because it is already clear that transactions involving conduits and intermediaries can include transactions involving multiple intermediaries, for example, multiple intermediary lenders in a fact pattern similar to that in proposed § 1.59A–9(c)(4) (Example 4), and thus expanding that example to involve another intermediary would be redundant.

Other comments asked for a clarification that the anti-abuse rule for transactions designed to inflate the denominator of the base erosion percentage applies only to non-economic deductions such as those described in the example in proposed § 1.59A–9(c)(5) (Example 5). One comment recommended that the rule be limited to deductions and losses incurred for “the” principal purpose of increasing the denominator. The comment expressed a concern that the rule could be interpreted as applying to deductions and losses on transactions undertaken in the ordinary course of a taxpayer's business. The final regulations do not change the standard for determining whether transactions that increase the denominator of the base erosion percentage are abusive.

Narrowing the rule to apply only to transactions where the single principal purpose is to increase the denominator of the base erosion percentage would make it difficult to administer in all but the most egregious cases. Further, it is a common formulation for anti-abuse rules to apply when “a principal purpose” or “one of the principal purposes” of a transaction is to avoid a particular provision. *See*, for example, section 954(h)(7)(A), (C), and (D); section 965(c)(3)(F); *see also* 60 FR 46500, 46501 (rejecting comments requesting that an anti-avoidance rule of § 1.954–1(b)(4) apply only if a purpose of first importance, rather than a principal purpose, was to avoid the de minimis test of § 1.954–1(b)(1)(i) because the suggested standard would be “significantly more subjective” than the test adopted and therefore inadministrable). However, the final regulations address the requests for clarity regarding the treatment of transactions entered into in the ordinary course of a taxpayer's business by adding a new example of the application of § 1.59A–9(b)(2). *See* § 1.59A–9(c)(7).

One comment requested that the anti-abuse rule with respect to the disaffiliation of banks and registered securities dealers be removed. The comment expressed a concern that proposed § 1.59A–9(b)(3) could effectively prevent taxpayers from disaffiliating a bank or registered securities dealer, notwithstanding the fact that disaffiliation could have other non-tax effects. The comment suggested that if a disaffiliation made sense from a business perspective and is permissible under applicable banking and securities rules, the Treasury Department and the IRS should not treat disaffiliation as abusive. The Treasury Department and the IRS have determined that disaffiliation of a bank or registered securities dealer could be abusive in certain circumstances, such as the interposition of entities other than “ineligible corporations” (as defined in section 1504(b)) with a principal purpose of avoiding the rules applicable to banks and registered securities dealers. Moreover, in developing guidance under various Code provisions, the Treasury Department and IRS often consider that disaffiliation could potentially avoid the purposes of a provision. *See*, for example, § 1.904(i)–1, which similarly limits the use of deconsolidation to avoid foreign tax credit limitations. *See* 59 FR 25584. Therefore, the final regulations retain § 1.59A–9(b)(3). However, the final regulations address

the concern raised by the comment by providing examples to clarify the types of transactions that the Treasury Department and the IRS consider to be abusive. *See* § 1.59A–9(c)(8) and (9).

Finally, a comment recommended excluding from the anti-abuse rule transactions entered into, or pursuant to a binding commitment that was in effect, before the date of public announcement of certain provisions in section 59A. The final regulations do not adopt this recommendation. The anti-abuse rule in § 1.59A–9 is based on the specific grant of authority in section 59A(i), and the Treasury Department and the IRS decline to adopt a grandfathering rule when no such rule was adopted by statute.

## X. Rules Relating to Insurance Companies

Section 59A(d)(3) provides that the term “base erosion payment” includes any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments that are taken into account under sections 803(a)(1)(B) or 832(b)(4)(A). The preamble to the proposed regulations requests comments regarding several issues relating to insurance companies. Specifically, the preamble to the proposed regulations requests comments regarding certain reinsurance agreements and other commercial agreements with reciprocal payments that are settled on a net basis. REG–104259–18, 83 FR 65968 (December 21, 2018).

Comments were also requested with respect to whether claims payments for losses incurred and other deductible payments made by a domestic reinsurance company to a foreign related insurance company are base erosion payments within the scope of section 59A(d)(1). REG–104259–18, 83 FR 65968 (December 21, 2018). The proposed regulations, however, did not provide any exceptions specific to the insurance industry.

Comments received generally addressed whether (1) claims payments for losses incurred (claims payments) under reinsurance contracts should be treated as base erosion payments, and (2) certain payments made pursuant to reinsurance contracts should be netted. For a discussion of comments relating to life/non-life consolidated returns, *see* Part XI of this Summary of Comments and Explanation of Revisions.

### A. Reinsurance Claims Payments to a Related Foreign Insurance Company

The proposed regulations do not provide specific rules for payments by



a domestic reinsurance company to a related foreign insurance company. The preamble to the proposed regulations notes the treatment of claims payments for purposes of section 59A may be different for life insurance companies and non-life insurance companies. REG-104259-18, 83 FR 65968 (December 21, 2018). For a life insurance company, payments for claims or losses incurred are deductible pursuant to sections 805(a)(1); therefore, these payments are potentially within the scope of section 59A(d)(1). With respect to non-life insurance companies, however, the preamble to the proposed regulations notes that certain claims payments for losses incurred may be treated as reductions in gross income under section 832(b)(3), rather than deductions under section 832(c). To the extent not covered by section 59A(d)(3), these payments treated as reductions in gross income may not be within scope of section 59A.

Generally, comments requested that the final regulations provide an exception to the term “base erosion payment” for claims payments made by a domestic reinsurance company to a related foreign insurance company. Some comments recommended that the exception should apply only to claims payments with respect to reinsurance that ultimately relates to the risk of unrelated third parties. Comments also stated that there was no apparent policy reason for treating life and non-life insurance claims payments differently for purposes of section 59A, although one comment noted that this distinction between life and non-life insurance claims payments results from the different approaches taken in drafting section 801(b) and section 832(b)(3), and that the Code sometimes provides disparate results.

Comments explained that an exception for claims payments by a domestic reinsurance company to a related foreign insurance company would provide symmetrical treatment for life insurance companies and non-life insurance companies. In addition, comments noted that reinsurance transactions with respect to which outbound claims payments are made do not base erode because they result from insurance business that is moved into the United States; therefore, it is appropriate to provide an exception similar to the TLAC exception and the exception for foreign currency losses. As noted, several comments requested an exception for reinsurance claims payments only to the extent that the claims payments are with respect to policies ultimately insuring third-party risks. Comments stated that because the

reinsurance claims payments are payable only when an unrelated third party makes a claim under an insurance policy that the domestic insurance company has reinsured (and the nature of those claims payments are non-routine and often large and unpredictable), the timing and amount of the claims payment are not controlled by the related parties. Finally, comments noted that foreign regulatory requirements generally require that a local entity provide insurance to its residents; as a result of these regulatory requirements, domestic companies that want to provide insurance in many jurisdictions must do so by reinsuring a subsidiary established in the local jurisdiction.

Comments also addressed how an exception for claims payments should impact the base erosion percentage calculation. Generally, comments recommended that claims payments be excluded from the numerator, but included in the denominator. If claims payments were eliminated from the denominator, comments noted that a significant amount of business expenses would be removed from the base erosion percentage calculation. Several comments acknowledged that the final regulations may adopt an exception that applies to both the numerator and the denominator; in that case, comments recommended that claims payments should be eliminated from the denominator of the base erosion percentage only to the extent that the payments are made to a foreign related party. Comments also indicated that the ambiguity regarding whether a claims payment is a deduction or a reduction in gross income for non-life insurance companies could result in taxpayers taking inconsistent positions and may lead to controversy regarding the calculation of the denominator for the base erosion percentage.

Finally, several comments noted that certain self-help remedies with respect to claims payments are not available for insurance companies. First, because insurance companies are per se corporations under § 301.7701-2(b)(4), an election under § 301.7701-3 to treat a related foreign insurance company as a disregarded entity for U.S. tax purposes is unavailable. In addition, comments stated that regulators in some jurisdictions would prohibit a local insurance company from making an election to be treated as a U.S. taxpayer pursuant to section 953(d) if the election would result in U.S. withholding tax with respect to payments to policyholders.

Section 1.59A-3(b)(3)(ix) adopts the recommendation from these comments

and provides a specific exception for deductible amounts for losses incurred (as defined in section 832(b)(5)) and claims and benefits under section 805(a) (“claims payments”) paid pursuant to reinsurance contracts that would otherwise be within the definition of section 59A(d)(1), to the extent that the amounts paid or accrued to the related foreign insurance company are properly allocable to amounts required to be paid by such company (or indirectly through another regulated foreign insurance company), pursuant to an insurance, annuity, or reinsurance contract, to a person other than a related party. The final regulations also clarify that all claims payments are included in the denominator of the base erosion percentage, except to the extent excepted from the definition of a base erosion payment under § 1.59A-3(b)(3)(ix). This treatment in the denominator is consistent with the treatment in the final regulations of derivatives and QDPs (discussed in Part VII of this Summary of Comments and Explanation of Revisions), section 988 foreign exchange losses (discussed in Part IV.C.4 of this Summary of Comments and Explanation of Revisions), and deductions for services eligible for the SCM exception (discussed in Part IV.C.1 of this Summary of Comments and Explanation of Revisions).

#### *B. Netting With Respect to Insurance Contracts*

As discussed in Part IV.A.2 of this Summary of Comments and Explanation of Revisions, the amount of any base erosion payment is generally determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis. The proposed regulations do not provide an exception to this general rule with respect to reinsurance agreements.

Several comments recommended that the final regulations permit netting with respect to reinsurance contracts to better reflect the economics of the transactions. One comment suggested that the final regulations permit netting with respect to a single economic transaction where the parties exchange net value in the form of a single payment, which would include many reinsurance transactions. Other comments identified specific types of reinsurance transactions for which netting should or should not be permitted. For quota share reinsurance arrangements, comments noted that the proposed regulations provide that the gross amount of reinsurance premium is a base erosion payment without considering any inbound payments such

as reserve adjustments, ceding commissions, and claims payments. Other comments suggested that the amount of base erosion payments with respect to modified coinsurance (“modco”) and funds withheld reinsurance be determined on a net basis (particularly when settlement is on a net basis) in the final regulations to be consistent with the norm of paying tax on a net basis.

As background, reinsurance is the transfer from an insurer (referred to as the “ceding” company) to a reinsurer of all or part of the risk assumed under a policy or a group of policies. A traditional reinsurance agreement typically requires the ceding company to pay a reinsurance premium to the reinsurance company and the reinsurance company to pay a ceding commission to the ceding company. The reinsurance premium compensates the reinsurer for acquiring the reinsured obligations. The ceding commission compensates the ceding company for its expenses incurred in acquiring and managing the reinsured policies, and may include a profit margin. When the risks are transferred, the ceding company may reduce its reserves for the reinsured obligations, and the reinsurance company establishes its own reserves for the reinsured obligations. In terms of payment flows, it is common for the ceding commission owed under the reinsurance agreement to be netted against the reinsurance premium owed, such that the ceding company remits the reinsurance premium net of the ceding commission amount. However, both flows are typically separately identified in the contract and in any case represent reciprocal economic obligations. When losses are paid under the reinsured policies, depending on the terms of the reinsurance agreement, the reinsurer will have corresponding obligations to make payments to the ceding company (for example, the agreement may require the reinsurer to reimburse a percentage of total losses, or losses above a certain dollar threshold).

Under modco and similar funds-withheld reinsurance agreements, the ceding company retains the assets with respect to the policies reinsured and generally does not transmit an initial premium payment to the reinsurer under the agreement. The reinsuring company in a modco agreement is entitled to premiums and a share of investment earnings on certain assets, and the ceding company is entitled to expense allowances (similar to ceding commissions) and reimbursement for losses paid under the reinsured policies, but the parties make net settlement

payments based on each party’s overall entitlement under the agreement on a periodic basis. Comments noted that in this respect, the arrangement is similar to making settlement payments under a derivative contract. In both the modco and traditional reinsurance context, comments asserted that imposing tax on one leg of a reinsurance transaction (the premium payment) is not equitable and does not reflect the economics of the transaction.

A comment recommended that the final regulations exclude ceding commissions paid by a domestic insurance company to a foreign affiliate in exchange for the domestic insurance company’s reinsurance of foreign risk from the definition of a base erosion payment. The comment suggested that this exception would be similar to the exception for section 988 foreign currency losses and for TLAC securities because an insurance group should not have a base erosion payment when insurance regulators dictate the structure of reinsurance agreements. The comments noted that reinsurance involves substantial payments in both directions, including premiums, ceding commissions, and claims. The comment explained that a ceding commission compensates the reinsured for its policy acquisition costs plus a small profit component and noted that a substantial amount of the commissions are reimbursements for third party expenses for many lines of business. For most reinsurance contracts, a comment noted that ceding commissions and premiums are separately stated in the reinsurance contract, but not separately paid. Instead, premiums are paid to the reinsurer net of the ceding commission.

Several comments expressed strong support for the determination in the proposed regulations that netting is not permitted with respect to reinsurance arrangements. Comments indicated that the result from the proposed regulations is appropriate under current law and necessary to achieve the legislative goals for the BEAT. Before the enactment of the BEAT, comments explained that foreign insurance groups had a significant competitive advantage over U.S.-based insurance companies because foreign groups were allowed to shift their U.S. earnings into low-tax jurisdictions using affiliated reinsurance payments. Comments asserted that section 59A identified reinsurance as a base erosion payment to close the loophole. Comments also noted that using gross amounts is consistent with the statutory annual statement that is the basis for determining taxable income under subchapter L. Comments explained that the use of gross

reinsurance premium, rather than net, is consistent with the excise tax imposed under section 4371, which computes the excise tax as a percentage of gross reinsurance payments, even for a funds-withheld or modco contract (where only net amounts are transferred between the contracting insurance companies). Finally, comments noted that when Congress determines that netting is appropriate with respect to insurance, it specifically permits netting. *See* sections 848(d)(1), 72(u)(2)(B), and 834(e); *see also* sections 803(a) and 832.

Some comments asserted that the statutory language of section 59A(d)(3), which provides that base erosion payments include consideration paid or accrued “for any reinsurance payments which are taken into account under sections 803(a)(1)(B) or 832(b)(4)(A),” requires treating only the net amounts paid by a domestic company under a modco-type reinsurance contract as base erosion payments. For example, in the life insurance context, section 803(a)(1) defines “premiums” as:

(A) The gross amount of premiums and other consideration on insurance and annuity contracts, less

(B) return premiums, and premiums and other consideration arising out of indemnity reinsurance.

Further, section 59A(c)(2)(A)(iii)(I) closely tracks section 803(a)(1) in its definition of base erosion tax benefit in the life insurance context as the amount by which “gross premiums and other consideration on insurance and annuity contracts” are reduced by “premiums and other consideration arising out of indemnity reinsurance.” These comments suggested that the phrase “consideration arising out of indemnity reinsurance” suggests a broader view of the transaction than just reinsurance premiums and is best interpreted as referring to the net cash settlement payments under a modco-type reinsurance contract, rather than the gross amount identified in the contract as reinsurance premium.

Other comments disagreed with this characterization and noted that section 59A(d)(3) is describing consideration paid or accrued for reinsurance—that is, payments moving in one direction from the taxpayer to foreign related party—without describing offsetting or reciprocal payments. The comments noted that the phrase “arising out of indemnity reinsurance” was merely lifted from preexisting section 803(a)(1)(B), rather than being selected deliberately by Congress to account for both inflows and outflows under a reinsurance contract. They noted further that section 803(a)(1)(B) and its non-life counterpart, section 832(b)(4), use

parallel structures for measuring the amount of premiums included in insurance company gross income, starting with total premiums received, and reducing that total by premiums paid for reinsurance and by return premiums (that is, premium amounts refunded to the policyholder). The two provisions do not provide for additional offsets based on obligations flowing in the other direction, such as ceding commissions or reinsurance claim payments owed.

Some comments asserted that foreign insurers may decide to reduce their capacity, discontinue lines of business, or increase pricing as a result of section 59A. Those comments acknowledged that domestic reinsurers may pick up the increased capacity, but warned that the shift to domestic reinsurers would concentrate the insured risk in the United States rather than spreading it globally, resulting in less risk diversification (a key element of insurance risk management). Other comments disagreed with this contention, noting that global reinsurance capacity has remained strong and that premium increases have been negligible since the enactment of section 59A.

In contrast, a comment asserted in the context of reinsurance that it was clear that the law applies on a gross basis, both based on the plain language of the statute and the intent of Congress, and that relevant policy considerations weigh heavily in favor of applying the BEAT on a gross basis. The comment explained that because the reinsurance transactions at issue are between related parties, they are not necessarily at arm's length. Further, according to the comment, the legislative purpose of section 59A was to level the playing field between U.S. and foreign-owned companies, which can only be advanced if section 59A is applied on a gross basis.

The final regulations do not adopt the recommendations that payments made under a reinsurance contract be netted for purposes of determining the amount of a base erosion payment, unless netting would otherwise be permitted for U.S. federal income tax purposes. Section 59A's requirements are best interpreted in the context of the existing body of tax law and regulations. As discussed in Part IV.A.3 of this Summary of Comments and Explanation of Revisions, amounts of income and deduction are generally determined on a gross basis under the Code, and unless a rule permits netting (so that there is no deduction or the deduction is a reduced amount, as opposed to a

deduction offset by an item of income), no netting is permitted.

Although comments asserted that section 59A(d)(3) (defining a base erosion payment as including certain reinsurance payments) requires the netting of ceding commissions and other payments from the related foreign reinsurance company against reinsurance premiums, the Treasury Department and IRS are not persuaded by arguments that the language of section 59A(d)(3) mandates that result. Whether payments under particular types of reinsurance contracts (for example, modco) may be netted for purposes of section 59A is determined based on the existing rules in the Code and regulations regarding netting. The subchapter L provisions cited in section 59A(d)(3) (section 803(a)(1)(B) for life insurance companies and section 832(b)(4)(A) for non-life insurance companies) do not provide for netting of ceding commissions, claims payments or other expenses against premiums.

With respect to the comment that modco and other reinsurance contracts that are periodically settled on a net basis are substantially similar to derivative contracts, the Treasury Department and IRS note that Congress specified in section 59A(h)(4)(C) that the term "derivative" does not include insurance contracts. This indicates that Congress did not intend for agreements with derivative-like characteristics that are also insurance contracts to be treated as derivatives for purposes of section 59A.

With respect to comments that ceding commissions should be broken down into components and not treated as base erosion payments to the extent that they reimburse amounts paid to third parties, this scenario is not materially different from those described in comments received from taxpayers in other industries and discussed in Part IV.A.1 of this Summary of Comments and Explanation of Revisions. These other comments described various scenarios in which a domestic corporation makes a deductible payment to a foreign related party, and that foreign related party in turn makes deductible payments to unrelated third parties. Therefore, the final regulations do not adopt a narrower regulatory exception for payments to foreign related insurance companies that arise in connection with a regulatory requirement.

## **XI. Comments and Changes to § 1.1502-59A**

### *A. In General*

Proposed § 1.1502-59A provides rules regarding the application of section 59A and the regulations thereunder to consolidated groups. Under these rules, 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. For example, items resulting from intercompany transactions (as defined in § 1.1502-13(b)(1)(i)) are disregarded for purposes of making the required computations.

Some comments requested clarification on what it means for intercompany transactions to be "disregarded" in making the required computations under section 59A. Generally, intercompany transactions should not change the consolidated taxable income or consolidated tax liability of a consolidated group. For example, where one member (S) sells depreciable property to another member (B) at a gain, S's gain on the sale is deferred. Every year, as B depreciates the property, S recognizes a portion of its deferred gain. As a result, the depreciation expense deducted by B that exceeds the depreciation expense the group would have deducted if S and B were divisions of a single entity ("additional depreciation") is offset by the amount of gain S recognizes each year, and the intercompany sale does not change the consolidated taxable income.

However, the base erosion percentage is generally computed based solely on deductions; income items are not relevant. Therefore, under the foregoing example, B's depreciation deduction would include the additional depreciation amount, but S's offsetting gain inclusion would be excluded from the base erosion percentage computation.

To make clear that intercompany transactions may not impact the BEAT consequences of a consolidated group, these final regulations clarify in § 1.1502-59A(b)(1) that items resulting from intercompany transactions are not taken into account in computing the group's base erosion percentage and BEMTA. Consequently, in the foregoing example, B's additional depreciation is not taken into account in computing the group's base erosion percentage.

In addition, some comments raised concerns that the proposed section 59A regulations and proposed § 1.1502-59A may be incompatible with the rules and framework of § 1.1502-47 for life-nonlife consolidated groups. The

Treasury Department and the IRS are analyzing these concerns and expect to address the issues in future proposed regulations, and thus reserve on this matter in the final regulations.

*B. New Rules Under § 1.1502–59A(c) When a Member Deconsolidates From a Consolidated Group With a Section 163(j) Carryforward*

Proposed section 1.1502–59A(c)(3) provides rules to determine whether a consolidated group's business interest deduction permitted under section 163(j) is a base erosion tax benefit. Due to the fungibility of money, these rules generally treat the consolidated group as a single entity and aggregate all members' current-year business interest expense paid to nonmembers. The current-year business interest expense deducted by members is then classified as an amount paid or accrued to a domestic related party, foreign related party, or unrelated party based on specified allocation ratios, which are based on the entire group's business interest expense paid. If members cannot fully deduct their current-year business interest expense, then the members' section 163(j) carryforwards are allocated a status as a domestic related carryforward, foreign related carryforward, or unrelated carryforward based on specified allocation ratios. Such status is taken into account for BEAT purposes in future years when the member deducts its section 163(j) disallowed business interest expense carryforward, whether the member remains in the group or deconsolidates.

A comment requested a special rule under § 1.1502–59A(c)(3) for certain situations in which a member (T) deconsolidates from a consolidated group (the original group) that was not an applicable taxpayer under section 59A and joins an unrelated consolidated group. Assume that, during the time T was a member of the original group, T incurred business interest expense that could not be fully deducted and has a section 163(j) disallowed business interest expense carryforward. T then deconsolidates from the original group and joins the new group, which is an applicable taxpayer under section 59A. The comment recommended allowing T to use the special allocation ratios under § 1.1502–59A(c)(3) of the new group for the taxable year of the acquisition (rather than the allocation ratios of the original group). The comment posited that the original group would not have determined or maintained information pertaining to the allocation ratios because the original group was not an applicable taxpayer.

The final regulations do not adopt this special rule. Whether a business interest expense deducted by members of a consolidated group is a base erosion tax benefit is determined on a single-entity basis, without regard to which member actually incurred the payment to the domestic related, foreign related, or unrelated party. Therefore, in the foregoing example, whether T's deduction of its section 163(j) disallowed business interest expense carryforward is a base erosion tax benefit must be determined by reference to the original group, not the new group.

Furthermore, to determine whether a consolidated group is an applicable taxpayer, the group generally must determine its base erosion percentage for the year. In order to do so, the group must apply the classification rule under § 1.1502–59A(c)(3) to its aggregate current-year business interest expense that was deducted. Therefore, the original group should have the information relevant to the classification rule under § 1.1502–59A(c)(3), regardless of whether it was an applicable taxpayer. Consequently, the final regulations do not adopt the rule recommended by the comment.

However, the final regulations provide two rules for situations in which a member deconsolidates from the original consolidated group with a section 163(j) carryforward. The first rule is an exception that applies if the original group was not an applicable taxpayer because it did not meet the gross receipts test in the year the business interest expense at issue was incurred. Under these circumstances, application of the classification rule under § 1.1502–59A(c)(3) would have been unnecessary within the original consolidated group with regard to the year in which the interest was paid or accrued. This special rule permits 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 section 163(j) disallowed business interest expense carryforward as a payment or accrual to a domestic related, foreign related, or unrelated party. The second rule applies if the deconsolidating member (or its acquiring consolidated group) fails to substantiate the status of its section 163(j) disallowed business interest expense carryforward from the original group. In that case, the section 163(j) disallowed business interest expense carryforward is treated as a payment or accrual to a foreign related party.

## Applicability Dates

Pursuant to section 7805(b)(1)(B), these final regulations (other than the reporting requirements for QDPs in § 1.6038A–2(b)(7), § 1.1502–2, and § 1.1502–59A) apply to taxable years ending on or after December 17, 2018. However, taxpayers may apply these final regulations in their entirety for taxable years ending before December 17, 2018. Taxpayers may also apply provisions matching §§ 1.59A–1 through 1.59A–9 from the Internal Revenue Bulletin (IRB) 2019–02 (<https://www.irs.gov/pub/irs-irbs/irb19-02.pdf>) in their entirety for all taxable years ending on or before December 6, 2019. Taxpayers choosing to apply the proposed regulations must apply them consistently and cannot selectively choose which particular provisions to apply.

Section 1.6038A–2(b)(7)(ix) applies to taxable years beginning Monday, June 7, 2021. No penalty under sections 6038A(d) or 6038C(c) will apply to a failure solely under § 1.6038A–2(a)(3), (b)(6), or (b)(7) that is corrected by March 6, 2020.

Pursuant to sections 1503(a) and 7805(b)(1)(A), § 1.1502–2 and § 1.1502–59A apply to taxable years for which the original consolidated Federal income tax return is due (without extensions) after December 6, 2019. However, taxpayers may apply § 1.1502–2 and § 1.1502–59A in their entirety for taxable years for which such a return is due (without extensions) before December 6, 2019.

## Statement of Availability of IRS Documents

IRS revenue procedures, revenue rulings, notices, and other guidance cited in this preamble are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

## Special Analyses

### I. Regulatory Planning and Review—Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of

reducing costs, of harmonizing rules, and of promoting flexibility. For purposes of Executive Order 13771, this rule is regulatory.

These final regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these regulations as economically significant under section 1(c) of the MOA. Accordingly, the OMB has reviewed these regulations.

#### A. Background

The Tax Cuts and Jobs Act of 2017 (the “Act”) added new section 59A, which applies to large corporations that have the ability to reduce U.S. tax liabilities by making deductible payments to foreign related parties. The Base Erosion and Anti-Abuse Tax (“BEAT”) is generally levied on certain large corporations that have deductions paid or accrued to foreign related parties that are greater than three percent of their total deductions (two percent in the case of certain banks or registered securities dealers), a determination referred to as the base erosion percentage test. Large corporations are those with gross receipts of \$500 million or more, as calculated under the rules of section 59A, a determination referred to as the gross receipts test. By taxing these corporations’ base erosion tax benefits, the BEAT “aims to level the playing field between U.S. and foreign-owned multinational corporations in an administrable way.” Senate Committee on Finance, Explanation of the Bill, S. Prt. 115–20, at 391 (November 22, 2017). The BEAT operates as a minimum tax, so a taxpayer is only subject to additional tax under the BEAT if the BEAT tax rate multiplied by the taxpayer’s modified taxable income exceeds the taxpayer’s regular tax liability adjusted for certain credits.

#### B. Need for the Final Regulations

Section 59A is largely self-executing, which means that it is binding on taxpayers and the IRS without any regulatory action. Although it is self-executing, the Treasury Department and the IRS recognize that section 59A provides interpretive latitude for taxpayers and the IRS which could create uncertainty and prompt a variety of taxpayer responses without further guidance. The final regulations are needed to address questions regarding the application of section 59A and to reduce compliance burden and

economic inefficiency that would be caused by uncertainty about how to calculate tax liability.

#### C. Overview of the Final Regulations

These final regulations provide guidance under section 59A regarding the determination of the tax with respect to base erosion payments for certain taxpayers with substantial gross receipts. They provide guidance for applicable taxpayers to determine the amount of BEAT liability and how to compute the components of the tax calculation.

Regulations under section 59A (§§ 1.59A–1 through 1.59A–10) provide details for taxpayers regarding whether a taxpayer is an applicable taxpayer and the computation of certain components of the base erosion minimum tax amount, including the amount of base erosion payments, the amount of base erosion payments that are treated as base erosion tax benefits, and modified taxable income. The regulations also provide specific guidance for banks, registered securities dealers, and insurance companies, and provide guidance in applying section 59A to amounts paid by and to partnerships. These regulations also establish anti-abuse rules to prevent taxpayers from taking measures to inappropriately circumvent section 59A.

Regulations under sections 383, 1502 and 6038A (§§ 1.383–1, 1.1502–2, 1.1502–59A, 1.6038A–1, 1.6038A–2, and 1.6038–4) provide rules for the application of section 59A with respect to limitations on certain capital losses and excess credits, consolidated groups and their members, and reporting requirements, which include submitting, in certain cases, new Form 8991, Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts.

#### D. Economic Analysis

##### 1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of these final regulations compared to a no-action baseline that reflects anticipated Federal income tax-related behavior in the absence of these final regulations.

##### 2. Summary of Economic Effects

These final regulations provide certainty and clarity to taxpayers regarding the meaning of terms and calculations they are required to apply under the BEAT provisions of the Act. In the absence of the enhanced specificity provided by these regulations, similarly situated taxpayers

might interpret the statutory rules of section 59A differently, potentially resulting in inefficient patterns of economic activity. For example, two otherwise similar taxpayers might structure an income-generating activity differently based solely on different assumptions about whether that activity will involve payments that are subject to the BEAT. If this tax-driven difference in business structures confers a competitive advantage on the less profitable enterprise, U.S. economic performance may suffer. This final regulatory guidance thus provides value by helping to ensure that economic agents face similar tax incentives, a tenet of economic efficiency.

The Treasury Department and the IRS project that under these final regulations, 3,500–4,500 taxpayers may be applicable taxpayers under the BEAT because those taxpayers (1) are U.S. shareholders of a foreign corporation, 25 percent foreign-owned corporations, or foreign corporations engaged in a trade or business within the United States and (2) have gross receipts of \$500 million or more without taking into account the gross receipts of members of its aggregate group. As many as 100,000–110,000 additional taxpayers may be applicable taxpayers as a result of being members of an aggregate group.<sup>5</sup>

The Treasury Department and the IRS recognize that in response to these final regulations, these businesses may alter the way they transact with related versus unrelated parties. They may make changes to financial arrangements, supply chain arrangements, or the locations of business activity, each in ways that increase or reduce the volume of payments made to a foreign affiliate that qualify as base erosion payments, relative to the decisions they would make under alternative regulatory approaches, including the no-action baseline. These differences in business activities may have economic effects beyond their effects on taxpayers’ tax liability.

The Treasury Department and the IRS have not attempted to quantify the economic effects of any changes in business activity stemming from these final regulations. The Treasury Department and the IRS do not have readily available data or models that predict with reasonable precision the decisions that businesses would make under the final regulations versus

<sup>5</sup> These estimates are based on current tax filings for taxable year 2017 and do not yet include the BEAT. At this time, the Treasury Department and the IRS do not have readily available data to determine whether a taxpayer that is a member of an aggregate group will meet all tests to be an applicable taxpayer for purposes of the BEAT.

alternative regulatory approaches. Nor do they have readily available data or models that would measure with reasonable precision the loss or gain in economic surplus resulting from these business decisions relative to the business decisions that would be made under an alternative regulatory approach. Such estimates would be necessary to quantify the economic effects of the final regulations versus alternative approaches.

Within these limitations, part I.D.3 of these Special Analyses (and the Summary of Comments and Explanation of Revisions) explains the rationale behind the final regulations and provides a qualitative assessment of the economic effects of the final regulations relative to the alternative regulatory approaches that were considered.

The Treasury Department and the IRS welcome comments on these conclusions and on the economic effects of the provisions described in the following sections.

### 3. Economic Effects of Provisions Substantially Revised From the Proposed Regulations

#### a. Securities Lending Transactions

Section 59A(h) includes an exception to base erosion payment status for certain payments by a corporation to a foreign related party pursuant to certain derivative contracts (qualified derivative payments, or QDPs). The statute further provides that the QDP exception does not apply to a payment pursuant to a derivative contract that would be treated as a base erosion payment if the payment was not made pursuant to a derivative contract. The final regulations specify how the QDP exception applies to securities lending transactions, a particular form of financial transaction. In this regard, the final regulations generally provide parity in the treatment of securities lending transactions and sale-repurchase transactions, a similar, alternative form of financial transaction. This part I.D.3.a discusses the treatment of securities lending transactions and sale-repurchase transactions under the final regulations. For a further description of securities lending transactions and sale-repurchase transactions, see Part VII.B of the Summary of Comments and Explanation of Revisions.

In general, a sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. Certain

sale-repurchase transactions are treated as secured debt for federal tax purposes; that is, the nominal seller of the securities in the sale-repurchase transaction is treated as transferring securities as collateral for a loan from the nominal buyer to the nominal seller. The fee paid by the nominal seller to the nominal buyer pursuant to this type of sale-repurchase contract is one example of a payment that does not qualify for the QDP exception.

In this type of sale-repurchase transaction, the nominal seller remains the beneficial owner of the securities for federal income tax purposes and is treated as a cash borrower from the nominal buyer. Because the nominal seller remains the beneficial owner of the securities for federal income tax purposes, when the nominal buyer receives any payments with respect to the securities and passes those payments through to the nominal seller (known as substitute payments), such as interest or dividends, the nominal seller is treated as receiving that payment directly from the issuer of the security for federal income tax purposes. Thus, the substitute payment is not considered a payment between the nominal seller and the nominal buyer for federal tax purposes. Consequently, even if the nominal buyer is a U.S. person and the nominal seller is a foreign related party, the substitute payments on the sale-repurchase agreement that is treated as a loan for federal tax purposes generally are not base erosion payments for the BEAT.

Certain securities lending transactions are economically similar to sale-repurchase transactions but are treated differently for federal income tax purposes. In some securities lending transactions, a securities lender also transfers securities to a securities borrower in exchange for an obligation that the securities borrower make certain payments to the securities lender and also return identical (though not necessarily the same) securities to the securities lender. In connection with the transfer of securities in this type of transaction, the securities borrower may also provide cash or other form of collateral to the securities lender, often with the same or greater value as the lent security. Economically, the securities lender in these transactions can be viewed as both a lender of securities to the counterparty, and a borrower of cash from the counterparty. In these respects, the securities lending transaction is economically similar to a sale-repurchase transaction.

However, in these securities lending transactions, the securities lender is no longer treated as the beneficial owner of

the securities for federal income tax purposes. As a result, when the securities borrower makes substitute payments (with respect to the securities) in the securities lending transaction, those substitute payments may be base erosion payments (without regard for the QDP exception) if the securities lender is a foreign related party because the substitute payments are treated as payments from the securities borrower to the securities lender for federal income tax purposes.

The proposed regulations state that sale-repurchase transactions are not eligible for the QDP exception. The proposed regulations further provide that securities lending transactions are not eligible for the QDP exception because the securities lending transactions are economically similar to sale-repurchase transactions. However, as discussed in this part I.D.3.a, substitute payments on a sale-repurchase transaction are not a base erosion payment because the nominal seller of the securities is treated as remaining the beneficial owner of the securities for federal income tax purposes. Comments observed that the proposed regulations thus failed to take into account the disparate tax treatment of substitute payments for sale-repurchase transactions and securities lending transactions for purposes of the BEAT.

To take into account the disparate treatment of the substitute payments in securities lending transactions, the final regulations remove the per se exclusion of securities lending transactions from the QDP exception. Instead, the final regulations more narrowly exclude the borrowing of cash pursuant to a securities lending transaction ("cash leg") from the QDP exception. This change provides symmetry with the treatment of a sale-repurchase transaction that is treated as a secured loan for federal income tax purposes. Under the final regulations, both a sale-repurchase transaction and the cash leg of a securities lending transaction are excluded from the QDP exception to the extent that they are treated as financings, and thus may be base erosion payments.

The final regulations no longer exclude payments attributable to the borrowing of securities pursuant to a securities lending transaction from qualifying for the QDP exception; as a result, substitute payments on the security may qualify for the QDP exception. This change in the final regulations provides general symmetry in the treatment of substitute payments made pursuant to sale-repurchase

transactions and securities lending transactions for purposes of the BEAT.

The final regulations also provide an anti-abuse rule to address a potentially abusive transaction characterized by an uncollateralized borrowing of securities that can be liquidated for cash in a multiple-step transaction that is economically similar to an uncollateralized cash loan.

Specifically, the Treasury Department and the IRS adopted an anti-abuse rule that takes into account two factors: (a) Whether the securities lending transaction or substantially similar transaction provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing and (b) whether the transaction is part of an arrangement that has been entered into with a principal purpose of avoiding the treatment of any payment with respect to the transaction as a base erosion payment.

The Treasury Department and the IRS considered an alternative anti-abuse rule that would have applied solely on the basis of the securities loan being undercollateralized. The Treasury Department and the IRS did not adopt this alternative in the final regulations because the Treasury Department and the IRS are cognizant that an objective mechanical rule based solely on the level of collateralization may be difficult for both taxpayers and the IRS to apply, in particular due to the high volume of transactions issued under varying conditions. Accordingly, the final regulations further provide that for the anti-abuse rule to apply, the transactions must also be part of an arrangement that has been entered into with a principal purpose of avoiding the

treatment of any payment with respect to the transaction as a base erosion payment. See §§ 1.59A–6(d)(2)(iii)(C); 1.59A–6(e)(2) (Example 2).

The Treasury Department and the IRS recognize that in response to these final regulations, businesses may increase the volume of certain securities lending transactions relative to the volume that would occur under alternative anti-abuse rules. The Treasury Department and the IRS project, however, that taxpayer response to these rules, and the relative economic effects of adoption of the final rule, will be minor given the wide range of financial transactions that applicable taxpayers currently engage in, the various roles that securities lending transactions play, and the relatively small difference in regulatory treatment between the final regulations and alternative anti-abuse rules.

The Treasury Department and the IRS have not attempted to provide a quantitative prediction of the change in the volume of securities lending transactions nor to quantify the economic effects of this potential shift that may result from the final regulations, relative to alternative regulatory approaches. The Treasury Department and the IRS do not have readily available data or models that predict with reasonable precision the types of intercompany arrangements that businesses would adopt under the final regulations versus alternative regulatory approaches. Nor do they have readily available data or models that would measure with reasonable precision the difference in returns or risk that would occur as a result of this shift in the volume of securities lending

transactions relative to the alternative regulatory approach. Such estimates would be necessary to quantify the economic effects of these final regulations over the treatment of securities lending transactions versus alternative regulatory approaches.

*Profile of affected taxpayers.* The taxpayers affected by these provisions of the final regulations are domestic banks and broker-dealers that engage in securities lending transactions with a foreign related party where the domestic bank or broker-dealer is the securities borrower that makes substitute payments to the foreign related party. The taxpayers affected are also foreign banks and broker-dealers that engage in these securities lending transactions with a foreign related party as part of their conduct of a U.S. trade or business.

To provide an estimate of taxpayers affected by the change to the QDP rule, the Treasury Department and the IRS used current tax filings for taxable year 2017 and examined the set of filers who marked-to-market securities and were (1) U.S. shareholders of a foreign corporation as indicated by the filing of Form 5471 or (2) otherwise potentially applicable taxpayers as indicated by the filing of Form 5472. This marked-to-market proxy is reasonable because the QDP exception applies only if a taxpayer recognizes gain or loss as if the derivative were sold for fair market value on the last day of the taxable year and treats that gain or loss as ordinary. Based on these tax data, the number of taxpayers estimated to be affected by these provisions of the final regulations is 900, based on counts of the forms shown in the accompanying table.

TAXPAYERS AFFECTED BY § 1.59A  
[Estimate based on current tax filings for taxable year 2017]

	Estimated impacted filer counts
Form 1120 with mark-to-market on Form M3 and Form 5471 and/or 5472 .....	750
Form 1120F who completed line u of the Additional Information and Form 5471 and/or 5472 .....	150

b. Section 988 Losses in the Denominator of the Base Erosion Percentage

Under section 59A, a taxpayer is subject to the BEAT only if the taxpayer meets the statutory tests to be an applicable taxpayer, including the base erosion percentage test. The base erosion percentage test is satisfied with respect to a taxpayer if the taxpayer (or, if the taxpayer is a member of an aggregate group, that aggregate group)

has a base erosion percentage of three percent or more. A lower threshold of two percent generally applies if the taxpayer, or a member of the taxpayer's aggregate group, is a member of an affiliated group that includes a domestic bank or registered securities dealer. The final regulations specify how losses from certain currency exchange transactions should be included in the base erosion percentage test.

Proposed § 1.59A–3(b)(3)(iv) provides that exchange losses from section 988 transactions described in § 1.988–1(a)(1) are excluded from the definition of base erosion payments. Section 988 transactions are generally transactions in which the amount that the taxpayer is entitled to receive (or required to pay) is denominated in terms of a nonfunctional currency or is determined by reference to one or more nonfunctional currencies. In the



proposed regulations, the Treasury Department and the IRS determined that this section 988 exception from the definition of a base erosion payment is appropriate because those losses do not present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party. Because exchange losses from section 988 transactions are excluded from the definition of base erosion payments in the proposed regulations, those losses are not included in the numerator of the base erosion percentage under the proposed regulations. The final regulations retain the exclusion of section 988 losses from the definition of base erosion payments and from the numerator of the base erosion percentage.

Proposed § 1.59A–2(e)(3)(ii)(D) also provides that exchange losses from section 988 transactions (including with respect to transactions with persons other than foreign related parties) are not included in the denominator when calculating the base erosion percentage for purposes of the base erosion percentage test. In response to comments, the final regulations restore the section 988 losses to the denominator when calculating the base erosion percentage, except to the extent of the amount of section 988 losses from transactions with foreign related parties that is also excluded from the numerator of the base erosion percentage.

As an alternative, the Treasury Department and the IRS considered removing all section 988 losses from the denominator of the base erosion percentage test. However, the Treasury Department and the IRS determined that it was appropriate to exclude from the denominator only the amounts that are excluded from the numerator because that is how other statutory exceptions from the BEAT are addressed in the base erosion percentage calculations. Specifically, for the QDP exception (discussed in Part I.D.3.a of this Special Analysis) and the services cost method exception (discussed in Part IV.C.1 of the Summary of Comments and Explanation of Revisions) the amounts in the denominator of the base erosion percentage are also accounted for in this manner. That is, the denominator does include the amount of QDP deductions or services cost method deductions that are also excluded from the numerator of the base erosion percentage because of those exceptions.

The Treasury Department and the IRS project that under these final regulations, fewer taxpayers would be expected to satisfy the base erosion percentage test and therefore fewer would be liable for the BEAT, relative

to the alternative regulatory approach as specified in the proposed regulations. These final regulations include in the denominator of the base erosion percentage section 988 losses arising from foreign currency transactions with unrelated parties. Inclusion of such losses in the denominator, all else equal, reduces the base erosion percentage, and may increase the likelihood that businesses engage in incremental section 988 transactions with unrelated parties to reduce the base erosion percentage, relative to the proposed regulations. However, regulations under § 1.59A–9(b)(2) (anti-abuse rule addressing transactions to increase the amount of deductions taken into account in the denominator of the base erosion percentage computation) are expected to limit this behavior.

The Treasury Department and the IRS have not attempted to provide a quantitative prediction of the change in the volume of section 988 transactions nor to quantify the economic effects of this change resulting from the final regulations, relative to the alternative regulatory approach. The Treasury Department and the IRS do not have readily available data or models that predict with reasonable precision the volume of section 988 transactions that businesses might engage in under the final regulations versus the alternative regulatory approach because of the complex role that currency exchange plays for these businesses. The Treasury Department and the IRS further do not have readily available data or models that would measure with reasonable precision the difference in economic returns or volatility that these businesses would experience as a result of this shift in section 988 transactions relative to the alternative regulatory approach, again because of the complex role that currency exchange plays for these businesses. Such estimates would be necessary to quantify the economic effects of these final regulations over the treatment of section 988 transactions versus the alternative regulatory approach.

*Profile of affected taxpayers.* The taxpayers affected by these provisions of the final regulations generally are those taxpayers that engage in foreign currency transactions with unrelated parties and have section 988 losses that will be included in the denominator of the base erosion percentage under the final regulations.

The Treasury Department and the IRS have not estimated the number of these taxpayers because the Form 1120 series does not separately break out gains or losses from section 988 transactions. The sole form that breaks out section

988 gain and loss is Form 5471, which is filed by U.S. shareholders of a CFC. Information from Form 5471 is unlikely to be informative because a CFC is unlikely to be an applicable taxpayer.

#### 4. Economic Effects of Provisions Not Substantially Revised From the Proposed Regulations

##### a. Applicable Taxpayer for Aggregate Groups

A taxpayer is liable for the BEAT only if the taxpayer is an applicable taxpayer. In general, an applicable taxpayer is a corporation, other than a RIC, REIT, or an S corporation, that satisfies the gross receipts test and the base erosion percentage test. For purposes of these tests, members of a group of corporations related by certain specified percentages of stock ownership are aggregated. Section 59A(e)(3) refers to aggregation on the basis of persons treated as a single taxpayer under section 52(a) (controlled group of corporations), which includes both domestic and foreign persons. In the proposed regulations, the Treasury Department and the IRS determined that to implement the provisions of section 59A, it was necessary to treat foreign corporations as outside of the controlled group for purposes of applying the aggregation rules, except to the extent that the foreign corporation is subject to net income tax under section 882(a) (tax on income of foreign corporations connected with U.S. business). The final regulations also adopt this position.

Upon aggregation of domestic and foreign controlled groups of corporations, intra-aggregate group transactions are eliminated for purposes of the gross receipts test and base erosion percentage test. If aggregation were defined to include both domestic and all related foreign persons (*i.e.*, a “single employer” under section 52(a)), regardless of whether the foreign person was subject to tax in the United States, this would eliminate most base erosion payments, which are defined by section 59A(d)(1) as “any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowed under this chapter.” Without these base erosion payments, virtually no taxpayer or aggregate group would satisfy the base erosion percentage test; thus substantially all taxpayers (or the aggregate group of which the taxpayer was a member) would be excluded from the requirement to pay a tax equal to the base erosion minimum tax amount (BEMTA).

In the proposed regulations, the Treasury Department and the IRS considered an alternative of not providing guidance on the aggregation rule in the statute. Absent the proposed regulations, there would be uncertainty among taxpayers as to whether the tax equal to the BEMTA would apply to them. Without guidance, different taxpayers would likely take different positions regarding the determination of their status as an applicable taxpayer, which would result in inefficient decision-making and inconsistent application of the statute as taxpayers engage in corporate restructurings, or adjust investment and spending policies based on tax planning strategies to manage BEAT liability. No substantive comments objected to the general approach set forth in the proposed regulations.

#### b. Service Cost Method Exception

Section 59A(d)(5) provides an exception from the definition of a base erosion payment for an amount paid or accrued by a taxpayer for services if the services are eligible for the services cost method under section 482 (without regard to certain requirements under the section 482 regulations) and the amount constitutes the total services cost with no markup component. The statute is ambiguous as to whether the SCM exception (1) does not apply to a payment or accrual that includes a markup component, or (2) does apply to such a payment or accrual that includes a markup component, but only to the extent of the total services costs. The proposed regulations follow the latter approach. See REG-104259-18, 83 FR 65961 (December 21, 2018). The final regulations retain the same approach. See part IV.C.1 of the Summary of Comments and Explanation of Revisions.

Alternatives would have been to disallow the SCM exception for the entire amount of any payment that includes a markup component, or to not provide any guidance at all regarding the SCM exception. The Treasury Department and the IRS rejected the former approach. The section 482 regulations mandate intercompany pricing under an “arm’s length standard.” Under specific circumstances, the section 482 regulations provide that intercompany payments for services can be set by a taxpayer at the cost of providing the service with no profit markup. However, the section 482 regulations prohibit use of this cost-only SCM approach for services “that contribute significantly to fundamental risks of business success or failure” (the “business judgment rule”).

See § 1.482–9(b)(5). At arm’s length, such services generally would be priced to include a profit element to satisfy the market’s demand for, and supply of, services among recipients and providers. Section 59A(d)(5)(A) explicitly allows an exception from the BEAT for services that would be eligible for the SCM, “determined without regard to [the business judgment rule].” By allowing an exception from the BEAT for intercompany service payments that do not include a profit markup (*i.e.*, under the SCM transfer pricing method), but also for intercompany service payments that must apply a different transfer pricing method, and therefore generally would include a profit markup at arm’s length (*i.e.*, those subject to the business judgment rule), the statute creates ambiguity about the SCM exception’s application with respect to the portion of intercompany prices paid for services reflecting the cost of providing the services, when there is also a mark-up component. Thus, the proposed regulations provide that the SCM exception is available if there is a profit markup (provided that other requirements are satisfied), but the portion of any payment exceeding cost is not eligible for the SCM exception.

The Treasury Department and the IRS also rejected the option of not providing any guidance at all regarding the SCM exception because if taxpayers relied on statutory language alone, taxpayers would adopt different approaches due to ambiguity in the statute, leaving it open to differing statutory interpretations and an inconsistent application of the statute. Comments supported the SCM exception and recommended that final regulations adopt the approach from the proposed regulations.

#### c. Effectively Connected Income

The final regulations provide an exception from the definition of base erosion payment for payments to the U.S. branch of a foreign related person to the extent that the payments are treated as effectively connected income.

Under section 59A, whether a deductible payment is a base erosion payment is determined based on whether the recipient is a foreign person (as defined in section 6038A(c)(3)) and a related party. See section 59A(f). A foreign person means any person who is not a United States person. However, the Treasury Department and the IRS determined in the proposed regulations that establishing whether a payment is a base erosion payment based solely on the status of the recipient as a foreign person is inconsistent with the statute’s

intent of eliminating base erosion. As a result, deductible payments to a foreign person that are treated as effectively connected income are subject to tax under section 871(b) and 882(a) in substantially the same manner as payments to a U.S. citizen or resident, or a domestic corporation, and, thus, such payments do not result in base erosion. Thus, such payments are treated as income to the recipient and subject to U.S. tax, substantially similar to any payment between related U.S. corporations. Further, treatment of effectively connected income payments to a foreign related party would produce different tax results for two similarly situated U.S. taxpayers. That is, if the taxpayer were to make a payment to a related U.S. corporation, the payment generally would not be subject to the BEAT, but if a taxpayer were to make a payment to a foreign person with respect to its effectively connected income, it would give rise to BEAT liability, despite the fact that in both cases the recipients include the payment in U.S. taxable income. The final regulations retain the same approach as the proposed regulations. See § 1.59A–3(b)(3)(iii). This approach provides consistency with the approach in the regulations to determining the applicable taxpayer for aggregate groups, which is discussed in part I.D.4.a of this Special Analysis, because this provision excludes from the definition of a base erosion payment those payments to members of the aggregate group that are also excluded from the base erosion percentage because the payments are also within the aggregate group.

The Treasury Department and the IRS considered an alternative of not providing this exception to the definition of a base erosion payment, but determined that it would be inconsistent to exclude a payment to the U.S. branch of a foreign related person from the base erosion percentage (a condition to the application of the BEAT) but not also exclude the same payment from the amount of base erosion payments (a factor in determining the amount of BEAT tax liability).

#### d. Modified Taxable Income

Modified taxable income is a taxpayer’s taxable income for the year calculated without regard to any base erosion tax benefit or the base erosion percentage of any allowable net operating loss deductions under section 172 (net operating loss deduction). As discussed in Part V.A. of the Summary of Comments and Explanation of Revisions, the proposed regulations

provide that modified taxable income is computed under the add-back method of adding back to taxable income the base erosion tax benefits and base erosion percentage of any net operating loss deductions. The regulations do not provide for computing modified taxable income by recomputing the tax base without base erosion tax benefits under an approach similar to the alternative minimum tax, which the Act repealed for corporations. Applying the recomputation method would require taxpayers to maintain records for separate carryforward balances for attributes, such as net operating loss deductions and business interest expense carryovers. These items are limited based on taxable income, so under the recomputation or alternative minimum tax-approach, there would most likely be different annual limitations and other computational differences for regular tax purposes and section 59A purposes. The final regulations retain the same approach as the proposed regulations. This add-back approach is expected to be less costly for taxpayers to apply than the recomputation approach because under the add-back approach, where amounts are only added to taxable income, taxpayers will not have to recompute their entire tax return on a different basis or maintain separate sets of records to track annual limitations on attributes such as net operating loss carryforwards or business interest expense carryforwards (and the IRS will not have to administer such a system). See Part V.A. of the Summary of Comments and Explanation of Revisions for a detailed discussion of the comments that were not adopted.

#### e. Payments to or From Partnerships

As discussed in Part VIII of the Summary of Comments and Explanation of Revisions section, these final regulations apply the “aggregate” approach to base erosion payments involving partnerships, which is to say that the regulations generally treat the partnership as an aggregation of its partners, with the partners viewed as entering into transactions. This aggregate approach is in contrast to the alternative “entity” approach that treats the partnership as an entity that engages in transactions. Because partnerships are passthrough entities that are not themselves subject to U.S. income tax and because the income of the partnership is taxable to the partners in the partnership, these final regulations apply the aggregate approach and provide that payments by a corporation to a partnership, and payments by a partnership to a corporation, are treated

in the first instance as payments to the partners in the partnership and in second instance as payments by the partners in the partnership. Under the alternative entity approach that assesses the partnership as a separate entity, a payment by an applicable taxpayer (corporation) to a related foreign partnership could be a base erosion payment even if all of the partners in the partnership are domestic persons.

Under the aggregate approach adopted in these final regulations, the applicable taxpayer (corporation) that makes a payment to a related foreign partnership with a partner or partners that are related foreign parties will determine whether it has made a base erosion payment by treating the amount as having been paid to each partner of the partnership. Conversely, also in the absence of this aggregate approach, a payment by an applicable taxpayer (corporation) to a related domestic partnership would not be a base erosion payment even if some or all of the partners in the partnership are foreign related parties. As with a payment to a related foreign partnership, under the aggregate approach adopted in these final regulations, the applicable taxpayer (corporation) that makes a payment to a related domestic partnership with a partner or partners that are related foreign parties will determine whether it has made a base erosion payment by treating the amount as having been paid to each partner of the partnership. This approach is thus neutral in both preventing potential abuse and preventing potential overbreadth.

The final regulations retain the same general approach that was provided in the proposed regulations. See Part VIII of the Summary of Comments and Explanation of Revisions. The Treasury Department and the IRS considered an alternative of not providing guidance on transactions involving partnerships; however, as discussed in this part I.D.4.e, these final regulations eliminate the distortion that would otherwise be present if determination of whether a payment is a base erosion payment is made by reference to the partnership, rather than by reference to the partners. For example, in the absence of these final regulations, taxpayers might be incentivized to route payments through a domestic partnership that is formed by foreign persons as an intermediary to avoid the BEAT. Conversely, in the absence of the final regulations, taxpayers would be incentivized to restructure to avoid making any payments to a foreign partnership that has partners that are solely domestic because such payment could be

inappropriately classified as a base erosion payment.

#### f. Anti-Abuse and Reporting Requirements

Section 59A(i) provides the Secretary authority to issue regulations and other guidance including for the purposes of preventing the avoidance of the purposes of section 59A. Pursuant to this specific grant of regulatory authority, § 1.59A–9 provides rules recharacterizing certain specified transactions as necessary to prevent the avoidance of section 59A, and provides examples. The Treasury Department and the IRS have determined that any compliance burdens or other economic costs created by the anti-abuse provisions are necessary to further the purposes of section 59A.

These final regulations also provide reporting requirements necessary to properly administer and enforce section 59A. In particular, the Treasury Department and the IRS have identified certain types of information from taxpayers who are applicable taxpayers for purposes of section 59A that will be required to be reported on Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code), and a new Form 8991, Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts. The regulations increase record keeping requirements for taxpayers relative to the baseline because additional information is to be reported on Form 5472 and Form 8991. The requirements added by the proposed regulations, however, derive directly from statutory changes that require information from applicable taxpayers and are necessary for the effective administration of section 59A.

## II. Paperwork Reduction Act

### 1. Collections of Information—Forms 8991, 5471, 5472, and 8858

The collections of information in the final regulations with respect to section 59A are in §§ 1.59A–3(b)(3)(i)(C), 1.59A–3(b)(4)(i)(D), and 1.6038A–2. In response to comments addressing the notice of proposed rulemaking preceding the final regulations, the Treasury Department and the IRS have revised the collection of information with respect to section 6038A. The revised collection of information with respect to sections 59A and 6038A is in § 1.6038A–2(b)(7)(ix).

The collection of information in § 1.59A–6(b)(2)(i) and § 1.6038A–2(b)(7)(ix) requires an applicable taxpayer that makes qualified derivative payments to report information regarding its qualified derivative payments on Form 8991 in order for the QDP exception from base erosion payment status to apply to any particular payment. In response to comments, § 1.59A–6(b)(2)(i) provides that a taxpayer satisfies the reporting requirement by reporting the aggregate amount of all QDPs (rather than the aggregate amount as determined by type of derivative contract as provided in

proposed § 1.6038A–2(b)(7)(ix)(A)) on Form 8991 or its successor form. To comply with these reporting requirements, taxpayers will need to develop systems to collect and report the relevant information. To separately determine the aggregate amount of QDPs by each specific type of derivative contract would add to the complexity of those systems. That additional complexity and compliance burden outweighs the utility to the IRS of receiving that information for each specific type of derivative contract. Section 1.59A–6(b)(2)(iv) also provides that during the transition period before

§ 1.59A–6(b)(2)(i) is applicable, taxpayers will not be deemed to have failed to satisfy the reporting requirement if the taxpayer reports the aggregate amount of qualified derivative payments in good faith. For purposes of the PRA, the reporting burden associated with § 1.59A–3(b)(4)(i)(D), § 1.59A–6(b)(2)(i) and § 1.6038A–2(b)(7)(ix) will be reflected in the PRA submission associated with the Form 8991 series (see chart at the end of this Part II of the Special Analysis section for the status of the PRA submission for this form).

## TAX FORM IMPACTED

Collection of information	Number of respondents (estimated)	Forms to which the information may be attached
§ 1.59A–3(b)(4)(i)(D) election to use-applicable financial statements .....	105,600	Form 8991 series.
§ 1.59A–6(b)(2)(i) and § 1.6038A–2(b)(7)(ix) requirement to report qualified derivative payments .....	105,600	Form 8991 series.

CDW.

The information collection requirements pursuant to § 1.59A–3(b)(3)(i)(C) are discussed further below. The collections of information pursuant to section 59A, except with respect to information collected under § 1.59A–3(b)(3)(i)(C), will be conducted by way of the following:

- Form 8991, Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts;
- Schedule G to the Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations;
- Part VIII of the updated Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business;
- Revised Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities.

For purposes of the Paperwork Reduction Act, the reporting burden associated with the collections of information with respect to section 59A, other than with respect to § 1.59A–3(b)(3)(i)(C), will be reflected in the IRS Forms 14029 Paperwork Reduction Act Submission, associated with Forms

5471 (OMB control numbers 1545–0123, and 1545–0074), 5472 (OMB control number 1545–0123), 8858 (OMB control numbers 1545–0123, 1545–0074, and 1545–1910), and 8991 (OMB control number 1545–0123).

The current status of the Paperwork Reduction Act submissions related to BEAT is provided in the following table. The BEAT provisions are included in aggregated burden estimates for the OMB control numbers listed below which, in the case of 1545–0123, represents a total estimated burden time, including all other related forms and schedules for corporations, of 3.157 billion hours and total estimated monetized costs of \$58.148 billion (\$2017) and, in the case of 1545–0074, a total estimated burden time, including all other related forms and schedules for individuals, of 1.784 billion hours and total estimated monetized costs of \$31.764 billion (\$2017). The burden estimates provided in the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and will in the future include

but not isolate the estimated burden of only the BEAT requirements. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the final regulations. The Treasury Department and IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burden that international tax provisions imposed prior to the Act. No burden estimates specific to the final regulations are currently available. The Treasury Department has not estimated the burden, including that of any new information collections, related to the requirements under the final regulations. Those estimates would capture both changes made by the Act and those that arise out of discretionary authority exercised in the final regulations. The Treasury Department and the IRS request comment on all aspects of information collection burdens related to the final regulations. In addition, when available, drafts of IRS forms are posted for comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.htm>.

Form	Type of filer	OMB No.(s)	Status
Form 5471 (including Schedule G).	Business (NEW Model) .....	1545–0123	Published in the <b>Federal Register</b> on 10/8/18. Public Comment period closed on 12/10/18.
Link: <a href="https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd">https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</a>			

Form	Type of filer	OMB No.(s)	Status
	Individual (NEW Model) .....	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3/2019. 60 Day <b>Federal Register</b> notice not published yet for full collection.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031</a> .		
Form 5472 (including Part VIII)	Business (NEW Model) .....	1545–0123	Published in the <b>Federal Register</b> on 10/11/18. Public Comment period closed on 12/10/18.
	Link: <a href="https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd">https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</a> .		
Form 8858 .....	All other Filers (mainly trusts and estates) (Legacy system).	1545–1910	Published in the <b>Federal Register</b> on 10/30/18. Public Comment period closed on 11/30/18. ICR in process by the Treasury Department as of 9/6/18.
	Link: <a href="https://www.federalregister.gov/documents/2018/10/30/2018-23644/agency-information-collection-activities-submission-for-omb-review-comment-request-multiple-irs">https://www.federalregister.gov/documents/2018/10/30/2018-23644/agency-information-collection-activities-submission-for-omb-review-comment-request-multiple-irs</a> .		
	Business (NEW Model) .....	1545–0123	Published in the <b>Federal Register</b> on 10/8/18. Public Comment period closed on 12/10/18.
	Link: <a href="https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd">https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</a> .		
	Individual (NEW Model) .....	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3–2019. 60 Day <b>Federal Register</b> notice not published yet for full collection.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031</a> .		
Form 8991 .....	Business (NEW Model) .....	1545–0123	Published in the <b>Federal Register</b> on 10/11/18. Public Comment period closed on 12/10/18.
	Link: <a href="https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd">https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</a> .		

## RELATED NEW OR REVISED TAX FORMS

	New	Revision of existing form	Number of respondents (2018, estimated)
Form 8991 .....	Y	.....	3,500–4,500
Form 5471, Schedule G .....	.....	Y	15,000–25,000
Form 5472, Part VIII .....	Y	.....	80,000–100,000
Form 8858 .....	.....	Y	15,000–25,000

The numbers of respondents in the Related New or Revised Tax Forms table were estimated by Treasury's Office of Tax Analysis based on data from IRS Compliance Planning and Analytics using tax return data for tax years 2015 and 2016. Data for Form 8991 represent preliminary estimates of the total number of taxpayers which may be required to file the new Form 8991. Only certain large corporate taxpayers with gross receipts of at least \$500 million are expected to file this form. Data for each of the Forms 5471, 5472, and 8858 represent preliminary estimates of the total number of taxpayers that are expected to file these information returns regardless of whether that taxpayer must also file Form 8991.

The Treasury Department and the IRS project that 3,500–4,500 taxpayers may be applicable taxpayers under the BEAT. This estimate is based on the number of filers that (1) filed the Form 1120 series of tax returns (except for the Form 1120–S), (2) filed a Form 5471 or Form 5472, and (3) reported gross receipts of at least \$500 million. Because an applicable taxpayer is defined under section 59A(e)(1)(A) as a corporation other than a regulated investment company, a real estate investment trust, or an S corporation, the Treasury Department and the IRS have determined that taxpayers who filed the Form 1120 series of tax returns will be most likely to be affected by these proposed regulations. Additionally, the Treasury Department

and the IRS estimated the number of filers likely to make payments to a foreign related party based on filers of the Form 1120 series of tax returns who also filed a Form 5471 or Form 5472 to determine the number of respondents. Finally, because an applicable taxpayer is defined under section 59A(e)(1)(B) as a taxpayer with average annual gross receipts of at least \$500 million for the 3-taxable-year period ending with the preceding taxable year, the Treasury Department and the IRS estimated the scope of respondents based on the amount of gross receipts reported by taxpayers filing the Form 1120 series of tax returns.

These projections are based solely on data with respect to the taxpayer, without taking into account any

members of the taxpayer's aggregate group. As many as 105,600 additional taxpayers may be applicable taxpayers as a result of being members of an aggregate group.<sup>6</sup> This estimate is based on the number of taxpayers who filed a Form 1120 and also filed a Form 5471 or a Form 5472, but without regard to the gross receipts test.

## 2. Collection of Information—§ 1.59A–3(b)(3)(i)(C)

The information collection requirements pursuant to § 1.59A–3(b)(3)(i)(C) will be satisfied by the taxpayer maintaining permanent books and records that are adequate to verify the amount charged for the services and the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of the services, calculation of the amount of profit mark-up (if any) paid for the services, and sufficient documentation to allow verification of the methods used to allocate and apportion the costs to the services.

The collection of information in § 1.59A–3(b)(3)(i)(C) is mandatory for taxpayers seeking to exclude certain amounts paid or accrued to a foreign related party for services from treatment as base erosion payments for purposes of section 59A (the “SCM exception to the BEAT”). Taxpayers seeking to rely on the SCM exception to the BEAT are aggregate groups of corporations with average annual gross receipts of at least \$500 million and that make payments to foreign related parties. The information required to be maintained will be used by the IRS for tax compliance purposes.

*Estimated total annual reporting burden:* 5,000 hours.

*Estimated average annual burden hours per respondent:* 2.5 hours.

*Estimated average cost per respondent (\$2017):* \$238.00.

*Estimated number of respondents:* 2,000. This estimate is based on the assumption that only a portion of taxpayers will qualify for the SCM exception to the BEAT, multiplied by the number of respondents shown above.

*Estimated annual frequency of responses:* Once.

Based on these estimates, the annual three-year reporting burden for those electing the SCM exemption is \$0.16

mn/yr (\$2017) ( $\$238 \times 2,000/3$ , converted to millions).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## III. Regulatory Flexibility Act

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). This certification is based on the fact that these regulations will primarily affect aggregate groups of corporations with average annual gross receipts of at least \$500 million and that make payments to foreign related parties. Generally only large businesses both have substantial gross receipts and make payments to foreign related parties.

Pursuant to section 7805(f), the proposed regulations preceding these final regulations (REG–104259–18) were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

## IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately \$154 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

## V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state

law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

## VI. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 *et seq.*) (“CRA”). Under section 801(3) of the CRA, a major rule takes effect 60 days after the rule is published in the **Federal Register**. Notwithstanding this requirement, section 808(2) of the CRA allows agencies to dispense with the requirements of 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and the rule shall take effect at such time as the agency promulgating the rule determines.

Pursuant to section 808(2) of the CRA, the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date is unnecessary and contrary to the public interest. The Treasury Department and the IRS have determined that the rules in this Treasury decision (other than the reporting requirements for QDPs in § 1.6038A–2(b)(7), § 1.1502–2(a)(9), and § 1.1502–59A) shall take effect for taxable years ending on or after December 17, 2018. Section 14401(e) of the Act provides that section 59A applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. This means that the statute is currently effective, and taxpayers may be required to make payments under section 59A on a U.S. federal income tax return for 2018 tax years. These final regulations provide crucial guidance for taxpayers on how to apply the rules of section 59A, correctly calculate their liability under section 59A, and accurately file their U.S. federal income tax returns. Because the statute already requires taxpayers to comply with section 59A, a 60-day delay in the effective date is unnecessary and contrary to the public interest.

## Drafting Information

The principal authors of these final regulations are Azeka J. Abramoff, Sheila Ramaswamy, and Karen Walny of the Office of Associate Chief Counsel (International) and Julie Wang and John

<sup>6</sup> These estimates are based on current tax filings for taxable year 2017 and do not yet include the BEAT. At this time, the Treasury Department and the IRS do not have readily available data to determine whether a taxpayer that is a member of an aggregate group will meet all tests to be an applicable taxpayer for purposes of the BEAT.

P. Stemwedel of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by revising the entry for § 1.6038A-2 and adding entries for §§ 1.59A-0, 1.59A-1, 1.59A-2, 1.59A-3, 1.59A-4, 1.59A-5, 1.59A-6, 1.59A-7, 1.59A-8, 1.59A-9, 1.59A-10, 1.1502-59A, and 1.1502-100 to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

\* \* \* \* \*

§ 1.59A-0 also issued under 26 U.S.C. 59A(i).

§ 1.59A-1 also issued under 26 U.S.C. 59A(i).

§ 1.59A-2 also issued under 26 U.S.C. 59A(i).

§ 1.59A-3 also issued under 26 U.S.C. 59A(i).

§ 1.59A-4 also issued under 26 U.S.C. 59A(i).

§ 1.59A-5 also issued under 26 U.S.C. 59A(i).

§ 1.59A-6 also issued under 26 U.S.C. 59A(i).

§ 1.59A-7 also issued under 26 U.S.C. 59A(i).

§ 1.59A-8 also issued under 26 U.S.C. 59A(i).

§ 1.59A-9 also issued under 26 U.S.C. 59A(i).

§ 1.59A-10 also issued under 26 U.S.C. 59A(i).

\* \* \* \* \*

§ 1.1502-59A also issued under 26 U.S.C. 1502.

\* \* \* \* \*

§ 1.1502-100 also issued under 26 U.S.C. 1502.

\* \* \* \* \*

§ 1.6038A-2 also issued under 26 U.S.C. 6001, 6038A, and 6038C.

\* \* \* \* \*

■ **Par. 2.** Sections 1.59A-0 through 1.59A-10 are added to read as follows:

\* \* \* \* \*

Sec.

1.59A-0 Table of contents.

1.59A-1 Base erosion and anti-abuse tax.

1.59A-2 Applicable taxpayer.

1.59A-3 Base erosion payments and base erosion tax benefits.

1.59A-4 Modified taxable income.

1.59A-5 Base erosion minimum tax amount.

1.59A-6 Qualified derivative payment.

1.59A-7 Application of base erosion and anti-abuse tax to partnerships.

1.59A-8 [Reserved]

1.59A-9 Anti-abuse and recharacterization rules.

1.59A-10 Applicability date.

\* \* \* \* \*

#### § 1.59A-0 Table of contents.

This section contains a listing of the headings for §§ 1.59A-1, 1.59A-2, 1.59A-3, 1.59A-4, 1.59A-5, 1.59A-6, 1.59A-7, 1.59A-8, 1.59A-9, 1.59A-10.

#### § 1.59A-1 Base erosion and anti-abuse tax.

- (a) Purpose.
- (b) Definitions.
  - (1) Aggregate group.
  - (2) Applicable section 38 credits.
  - (3) Applicable taxpayer.
  - (4) Bank.
  - (5) Base erosion and anti-abuse tax rate.
  - (6) Business interest expense.
  - (7) Deduction.
  - (8) Disallowed business interest expense carryforward.
  - (9) Domestic related business interest expense.
  - (10) Foreign person.
  - (11) Foreign related business interest expense.
  - (12) Foreign related party.
  - (13) Gross receipts.
  - (14) Member of an aggregate group.
  - (15) Registered securities dealer.
  - (16) Regular tax liability.
  - (17) Related party.
    - (i) In general.
    - (ii) 25-percent owner.
    - (iii) Application of section 318.
  - (18) TLAC long-term debt required amount.
  - (19) TLAC securities amount.
  - (20) TLAC security.
  - (21) Unrelated business interest expense.

#### § 1.59A-2 Applicable taxpayer.

- (a) Scope.
- (b) Applicable taxpayer.
- (c) Aggregation rules.
  - (1) In general.
  - (2) Aggregate group determined with respect to each taxpayer.
    - (i) In general.
    - (ii) Reserved.
  - (3) Taxable year of members of an aggregate group.
  - (4) Reserved.
  - (5) Reserved.
  - (6) Reserved.
  - (7) Partnerships.
  - (8) Transition rule for aggregate group members with different taxable years.
    - (d) Gross receipts test.
      - (1) Amount of gross receipts.
      - (2) Taxpayer not in existence for entire three-year period.
    - (3) Gross receipts of foreign corporations.
    - (4) Gross receipts of an insurance company.
      - (5) Reductions in gross receipts.
      - (6) Gross receipts of consolidated groups.
    - (e) Base erosion percentage test.
      - (1) In general.
      - (2) Base erosion percentage test for banks and registered securities dealers.

- (i) In general.
- (ii) Aggregate groups.
- (iii) De minimis exception for banking and registered securities dealer activities.
- (3) Computation of base erosion percentage.
  - (i) In general.
  - (ii) Certain items not taken into account in denominator.
  - (iii) Effect of treaties on base erosion percentage determination.
  - (iv) Amounts paid or accrued between members of a consolidated group.
  - (v) Deductions and base erosion tax benefits from partnerships.
  - (vi) Mark-to-market positions.
  - (vii) Reinsurance losses incurred and claims payments.
  - (viii) Certain payments that qualify for the effectively connected income exception and another base erosion payment exception.
- (f) Examples.
  - (1) Mark-to-market.
  - (i) Facts.
  - (ii) Analysis.
  - (2) [Reserved]

#### § 1.59A-3 Base erosion payments and base erosion tax benefits.

- (a) Scope.
- (b) Base erosion payments.
  - (1) In general.
  - (2) Operating rules.
    - (i) In general.
    - (ii) Amounts paid or accrued in cash and other consideration.
    - (iii) Transactions providing for net payments.
    - (iv) Amounts paid or accrued with respect to mark-to-market position.
    - (v) Coordination among categories of base erosion payments.
    - (vi) Certain domestic passthrough entities.
      - (A) In general.
      - (B) Amount of base erosion payment.
      - (C) Specified domestic passthrough.
      - (D) Specified foreign related party.
    - (vii) Transfers of property to related taxpayers.
    - (viii) Reductions to determine gross income.
    - (ix) Losses recognized on the sale or transfer of property.
    - (3) Exceptions to base erosion payment.
      - (i) Certain services cost method amounts.
        - (A) In general.
        - (B) Eligibility for the services cost method exception.
        - (C) Adequate books and records.
        - (D) Total services cost.
      - (ii) Qualified derivative payments.
      - (iii) Effectively connected income.
        - (A) In general.
        - (B) Application to certain treaty residents.
        - (iv) Exchange loss on a section 988 transaction.
      - (v) Amounts paid or accrued with respect to TLAC securities and foreign TLAC securities.
        - (A) In general.
        - (B) Limitation on exclusion for TLAC securities.
        - (C) Scaling ratio.
        - (D) Average domestic TLAC securities amount.
        - (E) Average TLAC long-term debt required amount.



(F) Limitation on exclusion for foreign TLAC securities.

(1) In general.

(2) Foreign TLAC long-term debt required amount.

(3) No specified minimum provided by local law.

(4) Foreign TLAC security.

(vi) Amounts paid or accrued in taxable years beginning before January 1, 2018.

(vii) Business interest carried forward from taxable years beginning before January 1, 2018.

(viii) Specified nonrecognition transactions.

(A) In general.

(B) Other property transferred to a foreign related party in a specified nonrecognition transaction.

(C) Other property received from a foreign related party in certain specified nonrecognition transactions.

(D) Definition of other property

(E) Allocation of other property.

(ix) Reinsurance losses incurred and claims payments.

(A) In general.

(B) Regulated foreign insurance company.

(4) Rules for determining the amount of certain base erosion payments.

(i) Interest expense allocable to a foreign corporation's effectively connected income.

(A) Methods described in § 1.882–5.

(B) U.S.-booked liabilities determination.

(C) U.S.-booked liabilities in excess of U.S.-connected liabilities.

(D) Election to use financial statements.

(E) Coordination with certain tax treaties.

(1) In general.

(2) Hypothetical § 1.882–5 interest expense defined.

(3) Consistency requirement.

(F) Coordination with exception for foreign TLAC securities.

(ii) Other deductions allowed with respect to effectively connected income.

(iii) Depreciable property.

(iv) Coordination with ECI exception.

(v) Coordination with certain tax treaties.

(A) Allocable expenses.

(B) Internal dealings under certain income tax treaties.

(vi) Business interest expense arising in taxable years beginning after December 31, 2017.

(c) Base erosion tax benefit.

(1) In general.

(2) Exception to base erosion tax benefit.

(i) In general.

(ii) Branch-level interest tax.

(3) Effect of treaty on base erosion tax benefit.

(4) Application of section 163(j) to base erosion payments.

(i) Classification of payments or accruals of business interest expense based on the payee.

(A) Classification of payments or accruals of business interest expense of a corporation.

(B) Classification of payments or accruals of business interest expense by a partnership.

(C) Classification of payments or accruals of business interest expense paid or accrued to a foreign related party that is subject to an exception.

(1) ECI exception.

(2) TLAC interest and interest subject to withholding tax.

(ii) Ordering rules for business interest expense that is limited under section 163(j)(1) to determine which classifications of business interest expense are deducted and which classifications of business interest expense are carried forward.

(A) In general.

(B) Ordering rules for treating business interest expense deduction and disallowed business interest expense carryforwards as foreign related business interest expense, domestic related business interest expense, and unrelated business interest expense.

(1) General ordering rule for allocating business interest expense deduction between classifications.

(2) Ordering of business interest expense incurred by a corporation.

(3) Ordering of business interest expense incurred by a partnership and allocated to a corporate partner.

(d) Examples.

(1) Example 1: Determining a base erosion payment.

(i) Facts.

(ii) Analysis.

(2) Example 2: Interest allocable under

§ 1.882–5.

(i) Facts.

(ii) Analysis.

(3) Example 3: Interaction with section 163(j).

(i) Facts.

(ii) Analysis.

(A) Classification of business interest.

(B) Ordering rules for disallowed business interest expense carryforward.

(4) Example 4: Interaction with section 163(j); carryforward.

(i) Facts.

(ii) Analysis.

(A) Classification of business interest.

(B) Ordering rules for disallowed business interest expense carryforward.

(5) Example 5: Interaction with section 163(j); carryforward.

(i) Facts.

(ii) Analysis.

(6) Example 6: Interaction with section 163(j); partnership.

(i) Facts.

(ii) Partnership level analysis.

(iii) Partner level allocations analysis.

(iv) Partner level allocations for determining base erosion tax benefits.

(v) Computation of modified taxable income.

(7) Example 7: Transfers of property to related taxpayers.

(i) Facts.

(ii) Analysis.

(A) Year 1.

(B) Year 2.

#### § 1.59A–4 Modified taxable income.

(a) Scope.

(b) Computation of modified taxable income.

(1) In general.

(2) Modifications to taxable income.

(i) Base erosion tax benefits.

(ii) Certain net operating loss deductions.

(3) Rule for holders of a residual interest in a REMIC.

(c) Examples.

(1) Example 1: Current year loss.

(i) Facts.

(ii) Analysis.

(2) Example 2: Net operating loss deduction.

(i) Facts.

(ii) Analysis.

#### § 1.59A–5 Base erosion minimum tax amount.

(a) Scope.

(b) Base erosion minimum tax amount.

(1) In general.

(2) Calculation of base erosion minimum tax amount.

(3) Credits that do not reduce regular tax liability.

(i) Taxable years beginning on or before December 31, 2025.

(ii) Taxable years beginning after December 31, 2025.

(c) Base erosion and anti-abuse tax rate.

(1) In general.

(i) Calendar year 2018.

(ii) Calendar years 2019 through 2025.

(iii) Calendar years after 2025.

(2) Increased rate for banks and registered securities dealers.

(i) In general.

(ii) De minimis exception to increased rate for banks and registered securities dealers.

(3) Application of section 15 to tax rates in section 59A.

(i) New tax.

(ii) Change in tax rate pursuant to section 59A(b)(1)(A).

(iii) Change in rate pursuant to section 59A(b)(2).

#### § 1.59A–6 Qualified derivative payment.

(a) Scope.

(b) Qualified derivative payment.

(1) In general.

(2) Reporting requirements.

(i) In general.

(ii) Failure to satisfy the reporting requirement.

(iii) Reporting of aggregate amount of qualified derivative payments.

(iv) Transition period for qualified derivative payment reporting.

(3) Amount of any qualified derivative payment.

(i) In general.

(ii) Net qualified derivative payment that includes a payment that is a base erosion payment.

(c) Exceptions for payments otherwise treated as base erosion payments.

(d) Derivative defined.

(1) In general.

(2) Exceptions.

(i) Direct interest.

(ii) Insurance contracts.

(iii) Securities lending and sale-repurchase transactions.

(A) Multi-step transactions treated as financing.

(B) Special rule for payments associated with the cash collateral provided in a securities lending transaction or substantially similar transaction.

(C) Anti-abuse exception for certain transactions that are the economic equivalent of substantially unsecured cash borrowing.

(3) American depository receipts.

(e) Examples.

- (1) Example 1: Notional principal contract as QDP.  
 (i) Facts.  
 (ii) Analysis.  
 (2) Example 2: Securities lending anti-abuse rule.  
 (i) Facts.  
 (ii) Analysis.

**§ 1.59A-7 Application of base erosion and anti-abuse tax to partnerships.**

- (a) Scope.  
 (b) Application of section 59A to partnerships.  
 (c) Base erosion payment.  
 (1) Payments made by or to a partnership.  
 (2) Transfers of certain property.  
 (3) Transfers of a partnership interest.  
 (i) In general.  
 (ii) Transfers of a partnership interest by a partner.  
 (iii) Certain issuances of a partnership interest by a partnership.  
 (iv) Partnership interest transfers defined.  
 (4) Increased basis from a distribution.  
 (5) Operating rules applicable to base erosion payments.  
 (i) Single payment characterized as separate transactions.  
 (ii) Ordering rule with respect to transfers of a partnership interest.  
 (iii) Consideration for base erosion payment or property resulting in base erosion tax benefits.  
 (iv) Non-cash consideration.  
 (d) Base erosion tax benefit for partners.  
 (1) In general.  
 (2) Exception for base erosion tax benefits of certain small partners.  
 (i) In general.  
 (ii) Attribution.  
 (e) Other rules for applying section 59A to partnerships.  
 (1) Partner's distributive share.  
 (2) Gross receipts.  
 (i) In general.  
 (ii) Foreign corporation.  
 (3) Registered securities dealers.  
 (4) Application of sections 163(j) and 59A(c)(3) to partners.  
 (5) Tiered partnerships.  
 (f) Foreign related party.  
 (g) Examples.  
 (1) Facts.  
 (2) Examples.  
 (i) Example 1: Contributions to a partnership on partnership formation.  
 (A) Facts.  
 (B) Analysis.  
 (ii) Example 2: Section 704(c) and remedial allocations.  
 (A) Facts.  
 (B) Analysis.  
 (iii) Example 3: Sale of a partnership interest without a section 754 election.  
 (A) Facts.  
 (B) Analysis.  
 (iv) Example 4: Sale of a partnership interest with section 754 election.  
 (A) Facts.  
 (B) Analysis.  
 (v) Example 5: Purchase of depreciable property from a partnership.  
 (A) Facts.  
 (B) Analysis.  
 (vi) Example 6: Sale of a partnership interest to a second partnership.

- (A) Facts.  
 (B) Analysis.  
 (vii) Example 7: Distribution of cash by a partnership to a foreign related party.  
 (A) Facts.  
 (B) Analysis.  
 (viii) Example 8: Distribution of property by a partnership to a taxpayer.  
 (A) Facts.  
 (B) Analysis.  
 (ix) Example 9: Distribution of property by a partnership in liquidation of a foreign related party's interest.  
 (A) Facts.  
 (B) Analysis.

**§ 1.59A-8 [Reserved]**

**§ 1.59A-9 Anti-abuse and recharacterization rules.**

- (a) Scope.  
 (b) Anti-abuse rules.  
 (1) Transactions involving unrelated persons, conduits, or intermediaries.  
 (2) Transactions to increase the amount of deductions taken into account in the denominator of the base erosion percentage computation.  
 (3) Transactions to avoid the application of rules applicable to banks and registered securities dealers.  
 (4) Nonrecognition transactions.  
 (c) Examples.  
 (1) Facts.  
 (2) Example 1: Substitution of payments that are not base erosion payments for payments that otherwise would be base erosion payments through a conduit or intermediary.  
 (i) Facts.  
 (ii) Analysis.  
 (3) Example 2: Alternative transaction to base erosion payment.  
 (i) Facts.  
 (ii) Analysis.  
 (4) Example 3: Alternative financing source.  
 (i) Facts.  
 (ii) Analysis.  
 (5) Example 4: Alternative financing source that is a conduit.  
 (i) Facts.  
 (ii) Analysis.  
 (6) Example 5: Intermediary acquisition.  
 (i) Facts.  
 (ii) Analysis.  
 (7) Example 6: Offsetting transactions to increase the amount of deductions taken into account in the denominator of the base erosion percentage computation.  
 (i) Facts.  
 (ii) Analysis.  
 (8) Example 7: Ordinary course transactions that increase the amount of deductions taken into account in the denominator of the base erosion percentage computation.  
 (i) Facts.  
 (ii) Analysis.  
 (9) Example 8: Transactions to avoid the application of rules applicable to banks and registered securities dealers.  
 (i) Facts.  
 (ii) Analysis.  
 (10) Example 9: Transactions that do not avoid the application of rules applicable to banks and registered securities dealers.

- (i) Facts.  
 (ii) Analysis.  
 (11) Example 10: Acquisition of depreciable property in a nonrecognition transaction.  
 (i) Facts.  
 (ii) Analysis.  
 (12) Example 11: Transactions between related parties with a principal purpose of increasing the adjusted basis of property.  
 (i) Facts.  
 (ii) Analysis.

**§ 1.59A-10 Applicability date.**

**§ 1.59A-1 Base erosion and anti-abuse tax.**

(a) *Purpose.* This section and §§ 1.59A-2 through 1.59A-10 (collectively, the “section 59A regulations”) provide rules under section 59A to determine the amount of the base erosion and anti-abuse tax. Paragraph (b) of this section provides definitions applicable to the section 59A regulations. Section 1.59A-2 provides rules regarding how to determine whether a taxpayer is an applicable taxpayer. Section 1.59A-3 provides rules regarding base erosion payments and base erosion tax benefits. Section 1.59A-4 provides rules for calculating modified taxable income. Section 1.59A-5 provides rules for calculating the base erosion minimum tax amount. Section 1.59A-6 provides rules relating to qualified derivative payments. Section 1.59A-7 provides rules regarding the application of section 59A to partnerships. Section 1.59A-8 is reserved for rules regarding the application of section 59A to certain expatriated entities. Section 1.59A-9 provides anti-abuse rules to prevent avoidance of section 59A. Finally, § 1.59A-10 provides the applicability date for the section 59A regulations.

(b) *Definitions.* For purposes of this section and §§ 1.59A-2 through 1.59A-10, the following terms have the meanings provided in this paragraph (b).

- (1) *Aggregate group.* The term *aggregate group* means the group of corporations determined by—  
 (i) Identifying a controlled group of corporations as defined in section 1563(a), except that the phrase “more than 50 percent” is substituted for “at least 80 percent” each place it appears in section 1563(a)(1) and the determination is made without regard to sections 1563(a)(4) and (e)(3)(C), and  
 (ii) Once the controlled group of corporations is determined, excluding foreign corporations except with regard to income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or

regulations published under 26 CFR chapter I. Notwithstanding the foregoing, if a foreign corporation is subject to tax on a net basis pursuant to an applicable income tax treaty of the United States, it is excluded from the controlled group of corporations except with regard to income taken into account in determining its net taxable income.

(2) *Applicable section 38 credits.* The term *applicable section 38 credits* means the credits allowed under section 38 for the taxable year that are properly allocable to—

(i) The low-income housing credit determined under section 42(a),

(ii) The renewable electricity production credit determined under section 45(a), and

(iii) The investment credit determined under section 46, but only to the extent properly allocable to the energy credit determined under section 48.

(3) *Applicable taxpayer.* The term *applicable taxpayer* means a taxpayer that meets the requirements set forth in § 1.59A-2(b).

(4) *Bank.* The term *bank* has the meaning provided in section 581.

(5) *Base erosion and anti-abuse tax rate.* The term *base erosion and anti-abuse tax rate* means the percentage that the taxpayer applies to its modified taxable income for the taxable year to calculate its base erosion minimum tax amount. See § 1.59A-5(c) for the base erosion and anti-abuse tax rate applicable for the relevant taxable year.

(6) *Business interest expense.* The term *business interest expense*, with respect to a taxpayer and a taxable year, has the meaning provided in § 1.163(j)-1(b)(2).

(7) *Deduction.* The term *deduction* means any deduction allowable under chapter 1 of subtitle A of the Internal Revenue Code.

(8) *Disallowed business interest expense carryforward.* The term *disallowed business interest expense carryforward* has the meaning provided in § 1.163(j)-1(b)(9).

(9) *Domestic related business interest expense.* The term *domestic related business interest expense* for any taxable year is the taxpayer's business interest expense paid or accrued to a related party that is not a foreign related party.

(10) *Foreign person.* The term *foreign person* means any person who is not a United States person. For purposes of the preceding sentence, a United States person has the meaning provided in section 7701(a)(30), except that any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United

States is not a United States person. See § 1.59A-7(b) for rules applicable to partnerships.

(11) *Foreign related business interest expense.* The term *foreign related business interest expense* for any taxable year is the taxpayer's business interest expense paid or accrued to a foreign related party.

(12) *Foreign related party.* The term *foreign related party* means a foreign person, as defined in paragraph (b)(10) of this section, that is a related party, as defined in paragraph (b)(17) of this section, with respect to the taxpayer. In addition, for purposes of § 1.59A-3(b)(4)(v)(B) (relating to internal dealings under certain income tax treaties), a foreign related party also includes the foreign corporation's home office or a foreign branch of the foreign corporation. See § 1.59A-7(b), (c), and (f) for rules applicable to partnerships.

(13) *Gross receipts.* The term *gross receipts* has the meaning provided in § 1.448-1T(f)(2)(iv).

(14) *Member of an aggregate group.* The term *member of an aggregate group* means a corporation that is included in an aggregate group, as defined in paragraph (b)(1) of this section.

(15) *Registered securities dealer.* The term *registered securities dealer* means any dealer as defined in section 3(a)(5) of the Securities Exchange Act of 1934 that is registered, or required to be registered, under section 15 of the Securities Exchange Act of 1934.

(16) *Regular tax liability.* The term *regular tax liability* has the meaning provided in section 26(b).

(17) *Related party—(i) In general.* A *related party*, with respect to an applicable taxpayer, is—

(A) Any 25-percent owner of the taxpayer;

(B) Any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer; or

(C) A controlled taxpayer within the meaning of § 1.482-1(i)(5) together with, or with respect to, the taxpayer.

(ii) *25-percent owner.* With respect to any corporation, a *25-percent owner* means any person who owns at least 25 percent of—

(A) The total voting power of all classes of stock of the corporation entitled to vote; or

(B) The total value of all classes of stock of the corporation.

(iii) *Application of section 318.* Section 318 applies for purposes of paragraphs (b)(17)(i) and (ii) of this section, except that—

(A) “10 percent” is substituted for “50 percent” in section 318(a)(2)(C); and

(B) Section 318(a)(3)(A) through (C) are not applied so as to consider a

United States person as owning stock that is owned by a person who is not a United States person.

(18) *TLAC long-term debt required amount.* The term *TLAC long-term debt required amount* means the specified minimum amount of debt that is required pursuant to 12 CFR 252.162(a).

(19) *TLAC securities amount.* The term *TLAC securities amount* is the sum of the adjusted issue prices (as determined for purposes of § 1.1275-1(b)) of all TLAC securities issued and outstanding by the taxpayer, without regard to whether interest thereunder would be a base erosion payment absent § 1.59A-3(b)(3)(v).

(20) *TLAC security.* The term *TLAC security* means an eligible internal debt security, as defined in 12 CFR 252.161.

(21) *Unrelated business interest expense.* The term *unrelated business interest expense* for any taxable year is the taxpayer's business interest expense paid or accrued to a party that is not a related party.

#### § 1.59A-2 Applicable taxpayer.

(a) *Scope.* This section provides rules for determining whether a taxpayer is an applicable taxpayer. Paragraph (b) of this section defines an applicable taxpayer. Paragraph (c) of this section provides rules for determining whether a taxpayer is an applicable taxpayer by reference to the aggregate group of which the taxpayer is a member. Paragraph (d) of this section provides rules regarding the gross receipts test. Paragraph (e) of this section provides rules regarding the base erosion percentage test. Paragraph (f) of this section provides examples illustrating the rules of this section.

(b) *Applicable taxpayer.* For purposes of section 59A, a taxpayer is an applicable taxpayer with respect to any taxable year if the taxpayer—

(1) Is a corporation, but not a regulated investment company, a real estate investment trust, or an S corporation;

(2) Satisfies the gross receipts test of paragraph (d) of this section; and

(3) Satisfies the base erosion percentage test of paragraph (e) of this section.

(c) *Aggregation rules—(1) In general.* Solely for purposes of this section and § 1.59A-4, a taxpayer that is a member of an aggregate group determines its gross receipts and its base erosion percentage on the basis of the aggregate group. For these purposes, transactions that occur between members of the taxpayer's aggregate group that were members of the aggregate group as of the time of the transaction are not taken into account. In the case of a foreign

corporation that is a member of an aggregate group, only transactions that occur between members of the aggregate group and that relate to income effectively connected with, or treated as effectively connected with, the conduct of a trade or business in the United States are not taken into account for this purpose. In the case of a foreign corporation that is a member of an aggregate group and that is subject to tax on a net basis pursuant to an applicable income tax treaty of the United States, only transactions that occur between members of the aggregate group and that relate to income that is taken into account in determining its net taxable income are not taken into account for this purpose.

(2) *Aggregate group determined with respect to each taxpayer*—(i) *In general.* Solely for purposes of this section, an aggregate group is determined with respect to each taxpayer. As a result, the aggregate group of one taxpayer may be different than the aggregate group of another member of the taxpayer's aggregate group.

(ii) [Reserved]

(3) *Taxable year of members of an aggregate group.* Solely for purposes of this section, a taxpayer that is a member of an aggregate group measures the gross receipts and base erosion percentage of the aggregate group for a taxable year by reference to the taxpayer's gross receipts, base erosion tax benefits, and deductions for the taxable year and the gross receipts, base erosion tax benefits, and deductions of each member of the aggregate group for the taxable year of the member that ends with or within the taxpayer's taxable year.

(4) through (6) [Reserved]

(7) *Partnerships.* For the treatment of partnerships for purposes of determining gross receipts and base erosion tax benefits, see § 1.59A-7(e)(2) and (d), respectively.

(8) *Transition rule for aggregate group members with different taxable years.* If the taxpayer has a different taxable year than another member of the taxpayer's aggregate group (other member), and the other member is eligible for the exception in § 1.59A-3(b)(3)(vi) (amounts paid or accrued in taxable years beginning before January 1, 2018) with respect to a taxable year ending with or within the taxpayer's taxable year ("excepted taxable year"), the excepted taxable year of the other member is not taken into account for purposes of paragraph (e) of this section. This rule applies solely for purposes of determining whether a taxpayer is an applicable taxpayer under this section.

(d) *Gross receipts test*—(1) *Amount of gross receipts.* A taxpayer, or the

aggregate group of which the taxpayer is a member, satisfies the gross receipts test of this section if it has average annual gross receipts of at least \$500,000,000 for the three-taxable-year period ending with the preceding taxable year.

(2) *Taxpayer not in existence for entire three-year period.* If a taxpayer was not in existence for the entire three-year period referred to in paragraph (d)(1) of this section, the taxpayer determines a gross receipts average for the period that it was in existence (which includes gross receipts in the current year).

(3) *Gross receipts of foreign corporations.* With respect to any foreign corporation, only gross receipts that are taken into account in determining income that is, or is treated as, effectively connected with the conduct of a trade or business within the United States are taken into account for purposes of paragraph (d)(1) of this section. In the case of a foreign corporation that is a member of an aggregate group and that is subject to tax on a net basis pursuant to an applicable income tax treaty of the United States, the foreign corporation includes only gross receipts that are attributable to transactions taken into account in determining its net taxable income.

(4) *Gross receipts of an insurance company.* Solely for purposes of this section, 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 section 803(a)(1)(B) and section 832(b)(4)(A)), but are not reduced by any reinsurance premiums paid or accrued.

(5) *Reductions in gross receipts.* For purposes of this section, gross receipts for any taxable year are reduced by returns and allowances made during that taxable year.

(6) *Gross receipts of consolidated groups.* For purposes of this section, the gross receipts of a consolidated group are determined by aggregating the gross receipts of all of the members of the consolidated group. See § 1.1502-59A(b).

(e) *Base erosion percentage test*—(1) *In general.* A taxpayer, or the aggregate group of which the taxpayer is a member, satisfies the base erosion percentage test if its base erosion percentage is three percent or higher.

(2) *Base erosion percentage test for banks and registered securities dealers*—(i) *In general.* A taxpayer that is a member of an affiliated group (as

defined in section 1504(a)(1)) that includes a bank (as defined in § 1.59A-1(b)(4)) or a registered securities dealer (as defined in section § 1.59A-1(b)(15)) satisfies the base erosion percentage test if its base erosion percentage is two percent or higher.

(ii) *Aggregate groups.* An aggregate group of which a taxpayer is a member and that includes a bank or a registered securities dealer that is a member of an affiliated group (as defined in section 1504(a)(1)) is subject to the base erosion percentage threshold described in paragraph (e)(2)(i) of this section.

(iii) *De minimis exception for banking and registered securities dealer activities.* An aggregate group that includes a bank or a registered securities dealer that is a member of an affiliated group (as defined in section 1504(a)(1)) is not treated as including a bank or registered securities dealer for purposes of paragraph (e)(2)(i) of this section for a taxable year, if, for that taxable year, the total gross receipts of the aggregate group attributable to the bank or the registered securities dealer (or attributable to all of the banks and registered securities dealers in the group, if more than one) represent less than two percent of the total gross receipts of the aggregate group, as determined under paragraph (d) of this section. When there is no aggregate group, a consolidated group that includes a bank or a registered securities dealer is not treated as including a bank or registered securities dealer for purposes of paragraph (e)(2)(i) of this section for a taxable year, if, for that taxable year, the total gross receipts of the consolidated group attributable to the bank or the registered securities dealer (or attributable to all of the banks or registered securities dealers in the group, if more than one) represent less than two percent of the total gross receipts of the consolidated group, as determined under paragraph (d) of this section.

(3) *Computation of base erosion percentage*—(i) *In general.* The taxpayer's base erosion percentage for any taxable year is determined by dividing—

(A) The aggregate amount of the taxpayer's (or in the case of a taxpayer that is a member of an aggregate group, the aggregate group's) base erosion tax benefits (as defined in § 1.59A-3(c)(1)) for the taxable year, by

(B) The sum of—

(1) The aggregate amount of the deductions (including deductions for base erosion tax benefits described in § 1.59A-3(c)(1)(i) and base erosion tax benefits described in § 1.59A-3(c)(1)(ii)) allowable to the taxpayer (or in the case

of a taxpayer that is a member of an aggregate group, any member of the aggregate group) under chapter 1 of Subtitle A for the taxable year;

(2) The base erosion tax benefits described in § 1.59A-3(c)(1)(iii) with respect to any premiums or other consideration paid or accrued by the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, any member of the aggregate group) to a foreign related party for any reinsurance payment taken into account under sections 803(a)(1)(B) or 832(b)(4)(A) for the taxable year; and

(3) Any amount paid or accrued by the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, any member of the aggregate group) resulting in a reduction of gross receipts described in § 1.59A-3(c)(1)(iv) for the taxable year.

(ii) *Certain items not taken into account in denominator.* Except as provided in paragraph (e)(3)(viii) of this section, the amount under paragraph (e)(3)(i)(B) of this section is determined by not taking into account—

(A) Any deduction allowed under section 172, 245A, or 250 for the taxable year;

(B) Any deduction for amounts paid or accrued for services to which the exception described in § 1.59A-3(b)(3)(i) applies;

(C) Any deduction for qualified derivative payments that are not treated as base erosion payments by reason of § 1.59A-3(b)(3)(ii);

(D) Any exchange loss within the meaning of § 1.988-2 from a section 988 transaction as described in § 1.988-1(a)(1) that is not treated as a base erosion payment by reason of § 1.59A-3(b)(3)(iv);

(E) Any deduction for amounts paid or accrued to foreign related parties with respect to TLAC securities and foreign TLAC securities that are not treated as base erosion payments by reason of § 1.59A-3(b)(3)(v);

(F) Any reinsurance losses incurred and claims payments described in § 1.59A-3(b)(3)(ix); and

(G) Any deduction not allowed in determining taxable income for the taxable year.

(iii) *Effect of treaties on base erosion percentage determination.* See § 1.59A-3(c)(2) and (3).

(iv) *Amounts paid or accrued between members of a consolidated group.* See § 1.1502-59A(b).

(v) *Deductions and base erosion tax benefits from partnerships.* See § 1.59A-7(b), (d), and (e).

(vi) *Mark-to-market positions.* For any position with respect to which the taxpayer (or in the case of a taxpayer

that is a member of an aggregate group, a member of the aggregate group) applies a mark-to-market method of accounting for U.S. federal income tax purposes, the taxpayer must determine its gain or loss with respect to that position for any taxable year by combining all items of income, gain, loss, or deduction arising with respect to the position during the taxable year, regardless of how each item arises (including from a payment, accrual, or mark) for purposes of paragraph (e)(3) of this section. See paragraph (f)(1) of this section (*Example 1*) for an illustration of this rule. For purposes of section 59A, a taxpayer computes its losses resulting from positions subject to a mark-to-market regime under the Internal Revenue Code based on a single mark for the taxable year on the earlier of the last business day of the taxpayer's taxable year and the disposition (whether by sale, offset, exercise, termination, expiration, maturity, or other means) of the position, regardless of how frequently a taxpayer marks to market for other purposes. See § 1.59A-3(b)(2)(iii) for the application of this rule for purposes of determining the amount of base erosion payments.

(vii) *Reinsurance losses incurred and claims payments.* Except as provided in paragraph (e)(3)(ii)(F) of this section, amounts paid for losses incurred (as defined in section 832(b)(5)) and claims and benefits under section 805(a)(1) are taken into account for purposes of paragraph (e)(3)(i)(B)(1) of this section.

(viii) *Certain payments that qualify for the effectively connected income exception and another base erosion payment exception.* Subject to paragraph (c) of this section (transactions that occur between members of the taxpayer's aggregate group), a payment that qualifies for the effectively connected income exception described in § 1.59A-3(b)(3)(iii) and either the service cost method exception described in § 1.59A-3(b)(3)(i), the qualified derivative payment exception described in § 1.59A-3(b)(3)(ii), or the TLAC exception described in § 1.59A-3(b)(3)(v) is not subject to paragraph (e)(3)(ii)(B), (C), or (E) of this section and those amounts are included in the denominator of the base erosion percentage if the foreign related party who received the payment is not a member of the aggregate group.

(f) *Examples.* The following examples illustrate the rules of this section.

(1) *Mark-to-market—(i) Facts.* (A) Foreign Parent (FP) is a foreign corporation that owns all of the stock of domestic corporation (DC). FP is a foreign related party of DC under § 1.59A-1(b)(12). DC is a registered securities dealer that does not hold any securities for

investment. On January 1 of year 1, DC enters into two interest rate swaps for a term of two years, one with unrelated Customer A as the counterparty (position A) and one with unrelated Customer B as the counterparty (position B). Each of the swaps provides for semiannual periodic payments to be made or received on June 30 and December 31. No party makes any payment to any other party upon initiation of either of the swaps (that is, they are entered into at-the-money). DC is required to mark-to-market positions A and B for U.S. federal income tax purposes. DC is a calendar year taxpayer.

(B) For position A in year 1, DC makes a payment of \$150x on June 30, and receives a payment of \$50x on December 31. There are no other payments in year 1. On December 31, position A has a value to DC of \$110x (that is, position A is in-the-money by \$110x).

(C) For position B in year 1, DC receives a payment of \$120x on June 30, and makes a payment of \$30x on December 31. There are no other payments in year 1. On December 31, position B has a value to DC of (\$130x) (that is, position B is out-of-the-money by \$130x).

(ii) *Analysis.* (A) With respect to position A, based on the total amount of payments made and received in year 1, DC has a net deduction of \$100x. In addition, DC has a mark-to-market gain of \$110x. As described in paragraph (e)(3)(vi) of this section, the mark-to-market gain of \$110x is combined with the net deduction of \$100x resulting from the payments. Therefore, with respect to position A, DC has a gain of \$10x, and thus has no deduction in year 1 for purposes of section 59A.

(B) With respect to position B, based on the total amount of payments made and received in year 1, DC has net income of \$90x. In addition, DC has a mark-to-market loss of \$130x. As described in paragraph (e)(3)(vi) of this section, the mark-to-market loss of \$130x is combined with the net income of \$90x resulting from the payments. Therefore, with respect to position B, DC has a loss of \$40x, and thus has a \$40x deduction in year 1 for purposes of section 59A.

(2) [Reserved]

### **§ 1.59A-3 Base erosion payments and base erosion tax benefits.**

(a) *Scope.* This section provides definitions and related rules regarding base erosion payments and base erosion tax benefits. Paragraph (b) of this section provides definitions and rules regarding base erosion payments. Paragraph (c) of this section provides rules for determining the amount of base erosion tax benefits. Paragraph (d) of this section provides examples illustrating the rules described in this section.

(b) *Base erosion payments—(1) In general.* Except as provided in paragraph (b)(3) of this section, a *base erosion payment* means—

(i) Any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer and with respect to which a deduction is allowable under chapter 1

of subtitle A of the Internal Revenue Code;

(ii) Any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer in connection with the acquisition of property by the taxpayer from the foreign related party if the character of the property is subject to the allowance for depreciation (or amortization in lieu of depreciation);

(iii) Any premium or other consideration paid or accrued by the taxpayer to a foreign related party of the taxpayer for any reinsurance payments that are taken into account under section 803(a)(1)(B) or 832(b)(4)(A); or

(iv) Any amount paid or accrued by the taxpayer that results in a reduction of the gross receipts of the taxpayer if the amount paid or accrued is with respect to—

(A) A surrogate foreign corporation, as defined in section 59A(d)(4)(C)(i), that is a related party of the taxpayer (but only if the corporation first became a surrogate foreign corporation after November 9, 2017); or

(B) A foreign person that is a member of the same expanded affiliated group, as defined in section 59A(d)(4)(C)(ii), as the surrogate foreign corporation.

(2) *Operating rules*—(i) *In general*. The determination of the amount paid or accrued, and the identity of the payor and recipient of any amount paid or accrued, is made under general U.S. federal income tax law.

(ii) *Amounts paid or accrued in cash and other consideration*. For purposes of paragraph (b)(1) of this section, an amount paid or accrued includes an amount paid or accrued using any form of consideration, including cash, property, stock, a partnership interest, or the assumption of a liability, including any exchange transaction. A distribution of property that is not part of an exchange (such as a distribution under section 301, without regard to whether section 301(c)(1), (c)(2), or (c)(3) applies), is not received with respect to an amount paid or accrued and does not give rise to a base erosion payment. In contrast, a redemption of stock by a corporation within the meaning of section 317(b) (such as a redemption described in section 302(a) or (d) or section 306(a)(2)), or a transaction in which there is an exchange for stock (such as a section 304 or section 331 transaction), is an amount paid or accrued by the shareholder to the corporation (or by the acquiring corporation to the transferor in a section 304 transaction), without regard to the treatment of such transaction for U.S. federal income tax purposes. See paragraph (b)(3)(viii) of this section for an exception for

specified nonrecognition transactions (as defined in paragraph (b)(3)(viii)(A) of this section).

(iii) *Transactions providing for net payments*. Except as otherwise provided in paragraph (b)(2)(iv) of this section or as permitted by the Internal Revenue Code or the regulations, the amount of any base erosion payment is determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis. For this purpose, a right to make or receive payments on a net basis permits the parties to a transaction or series of transactions to settle obligations by offsetting any amounts to be paid by one party against amounts owed by that party to the other party. For example, any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments is not reduced by or netted against other amounts owed to the taxpayer from the foreign related party or by reserve adjustments or other returns.

(iv) *Amounts paid or accrued with respect to mark-to-market position*. For any transaction with respect to which the taxpayer applies the mark-to-market method of accounting for U.S. federal income tax purposes, the rules set forth in § 1.59A–2(e)(3)(vi) apply to determine the amount of the base erosion payment.

(v) *Coordination among categories of base erosion payments*. A payment that does not satisfy the criteria of one category of base erosion payment may be a base erosion payment described in one of the other categories.

(vi) *Certain domestic passthrough entities*—(A) *In general*. If a taxpayer pays or accrues an amount that would be a base erosion payment except for the fact that the payment is made to a specified domestic passthrough, then the taxpayer will be treated as making a base erosion payment to each specified foreign related party for purposes of section 59A and §§ 1.59A–2 through 1.59A–10. This rule has no effect on the taxation of the specified domestic passthrough under subchapter J or subchapter M of the Code (as applicable).

(B) *Amount of base erosion payment*. The amount of the base erosion payment is equal to the lesser of the amount paid or accrued by the taxpayer to or for the benefit of the specified domestic passthrough and the amount of the deduction allowed under section 561, 651, or 661 to the specified domestic passthrough with respect to amounts paid, credited, distributed, deemed distributed, or required to be distributed to a specified foreign related party.

(C) *Specified domestic passthrough*. For purposes of this paragraph (b)(2)(vi), specified domestic passthrough means:

(1) A domestic trust that is not a grantor trust under subpart E of subchapter J of chapter 1 of the Code (“domestic trust”) and which domestic trust is allowed a deduction under section 651 or section 661 with respect to amounts paid, credited, or required to be distributed to a specified foreign related party;

(2) A real estate investment trust (as defined in § 1.856–1(a)) that pays, or is deemed to pay, a dividend to a specified foreign related party for which a deduction is allowed under section 561; or

(3) A regulated investment company (as defined in § 1.851–1(a)) that pays, or is deemed to pay, a dividend to a specified foreign related party for which a deduction is allowed under section 561.

(D) *Specified foreign related party*. For purposes of this paragraph (b)(2)(vi), specified foreign related party means, with respect to a specified domestic passthrough, any foreign related party of a taxpayer that is a direct or indirect beneficiary or shareholder of the specified domestic passthrough.

(vii) *Transfers of property to related taxpayers*. If a taxpayer owns property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation) with respect to which paragraph (c)(1)(ii) of this section applies, and the taxpayer sells, exchanges, or otherwise transfers the property to another taxpayer that is a member of an aggregate group that includes the taxpayer (taking into account § 1.59A–7), any deduction for depreciation (or amortization in lieu of depreciation) by the transferee taxpayer remains subject to paragraph (c)(1)(ii) of this section to the same extent the amounts would have been so subject in the hands of the transferor. See paragraph (d)(7) of this section (*Example 7*) for an illustration of this rule.

(viii) *Reductions to determine gross income*. For purposes of paragraphs (b)(1)(i) and (ii) of this section, any amount resulting in a reduction to determine gross income under section 61, including an amount properly treated as cost of goods sold under the Code, is not a base erosion payment.

(ix) *Losses recognized on the sale or transfer of property*. If a taxpayer recognizes a loss on a sale or transfer of property to a foreign related party, the loss recognized with respect to the sale or transfer is not a deduction that would cause the payment to be treated as a base erosion payment under paragraph

(b)(1)(i) of this section. However, if a taxpayer uses property to make a payment to a foreign related party and the payment otherwise meets the requirements of paragraph (b)(1) of this section, the amount of the payment that is treated as a base erosion payment equals the fair market value of the property at the time of the transfer.

(3) *Exceptions to base erosion payment.* Paragraph (b)(1) of this section does not apply to the types of payments or accruals described in paragraphs (b)(3)(i) through (ix) of this section.

(i) *Certain services cost method amounts—(A) In general.* Amounts paid or accrued by a taxpayer to a foreign related party for services that meet the requirements in paragraph (b)(3)(i)(B) of this section, but only to the extent of the total services cost of those services.

Thus, any amount paid or accrued to a foreign related party in excess of the total services cost of services eligible for the services cost method exception (the mark-up component) remains a base erosion payment. For this purpose, services are an activity as defined in § 1.482–9(l)(2) performed by a foreign related party (the renderer) that provides a benefit as defined in § 1.482–9(l)(3) to the taxpayer (the recipient).

(B) *Eligibility for the services cost method exception.* To be eligible for the services cost method exception, all of the requirements of § 1.482–9(b) must be satisfied, except that:

(1) The requirements of § 1.482–9(b)(5) do not apply for purposes of determining eligibility for the service cost method exception in this section; and

(2) Adequate books and records must be maintained as described in paragraph (b)(3)(i)(C) of this section, instead of as described in § 1.482–9(b)(6).

(C) *Adequate books and records.*

Permanent books of account and records must be maintained for as long as the costs with respect to the services are incurred by the renderer. The books and records must be adequate to permit verification by the Commissioner of the amount charged for the services and the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of the services, calculation of the amount of profit mark-up (if any) paid for the services, and sufficient documentation to allow verification of the methods used to allocate and apportion the costs to the services in question in accordance with § 1.482–9(k). For example, where a renderer incurs costs that are attributable to performing a service for the taxpayer that includes services eligible for the services cost method

exception under this section (regardless of whether the taxpayer determined its payments for those services based on the services cost method) and another service that is not eligible for the services cost method exception, books and records must be maintained that show, among other things: the total amount of costs that are attributable to each of those services, the method chosen under § 1.482–9(k) to apportion the costs between the service eligible for the services cost method under this section and the other service, and the application of that method in calculating the amount eligible for the services cost method exception. This paragraph (b)(3)(i)(C) does not affect the recordkeeping requirements imposed by any other provision, including § 1.6001–1.

(D) *Total services cost.* For purposes of this section, total services cost has the same meaning as total services costs in § 1.482–9(j).

(ii) *Qualified derivative payments.*

Any qualified derivative payment as described in § 1.59A–6.

(iii) *Effectively connected income—*

(A) *In general.* Except as provided in paragraph (b)(3)(iii)(B) of this section, amounts paid or accrued to a foreign related party that are subject to U.S. federal income taxation as income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or regulations. Paragraph (b)(3)(iii) of this section applies only if the taxpayer receives a withholding certificate on which the foreign related party claims an exemption from withholding under section 1441 or 1442 because the amounts are effectively connected income.

(B) *Application to certain treaty residents.* If a foreign related party determines its taxable income pursuant to the business profits provisions of an applicable income tax treaty, amounts paid or accrued to the foreign related party that are taken into account in determining its taxable income.

(iv) *Exchange loss on a section 988 transaction.* Any exchange loss within the meaning of § 1.988–2 from a section 988 transaction described in § 1.988–1(a)(1) that is an allowable deduction and that results from a payment or accrual by the taxpayer to a foreign related party.

(v) *Amounts paid or accrued with respect to TLAC securities and foreign TLAC securities—(A) In general.* Except as provided in paragraph (b)(3)(v)(B) and (F) of this section, amounts paid or accrued to foreign related parties with

respect to TLAC securities and foreign TLAC securities.

(B) *Limitation on exclusion for TLAC securities.* The amount excluded under paragraph (b)(3)(v)(A) of this section is no greater than the product of the scaling ratio and amounts paid or accrued to foreign related parties with respect to TLAC securities for which a deduction is allowed.

(C) *Scaling ratio.* For purposes of this paragraph (b)(3)(v), the scaling ratio for a taxable year of a taxpayer is a fraction the numerator of which is 115 percent of the average TLAC long-term debt required amount and the denominator of which is the average TLAC securities amount. The scaling ratio may in no event be greater than one.

(D) *Average TLAC securities amount.* The average TLAC securities amount for a taxable year is the average of the TLAC securities amounts for the year, computed at regular time intervals in accordance with this paragraph. The TLAC securities amount used in calculating the average TLAC securities amount is computed on a monthly basis.

(E) *Average TLAC long-term debt required amount.* The average TLAC long-term debt required amount for a taxable year is the average of the TLAC long-term debt required amounts, computed on a monthly basis.

(F) *Limitation on exclusion for foreign TLAC securities—(1) In general.* The amount excluded under paragraph (b)(3)(v)(A) of this section for foreign TLAC securities is limited to the extent that interest deducted by a U.S. trade or business or permanent establishment with respect to foreign TLAC securities exceeds the interest expense associated with the foreign TLAC long-term debt required amount, applying the scaling ratio principles set forth under paragraphs (b)(3)(v)(B) through (E) of this section.

(2) *Foreign TLAC long-term debt required amount.* For purposes of paragraph (b)(3)(v) of this section, the term *foreign TLAC long-term debt required amount* means in the case of a trade or business or a permanent establishment in the United States, the lesser of—

(i) The specified minimum amount of debt, if any, required pursuant to a bank regulatory requirement imposed under the laws or regulations of a foreign country that are comparable to 12 CFR 252.160–167; or

(ii) The specified minimum amount of debt, if any, that would be required pursuant to 12 CFR 252.162(a) if the trade or business or permanent establishment were a U.S. person (as determined under Federal Reserve regulations).



(3) *No specified minimum provided by local law.* For purposes of paragraph (b)(3)(v)(F)(2)(ii) of this section, if the bank regulatory requirements imposed under the laws or regulations of a foreign country do not specify a minimum amount, the limitation for purposes of paragraph (b)(3)(v)(F)(2) of this section is determined by reference solely to paragraph (b)(3)(v)(F)(2)(ii) of this section.

(4) *Foreign TLAC security.* For purposes of paragraph (b)(3)(v) of this section, the term *foreign TLAC security* means an internal debt security issued under a bank regulatory requirement imposed under the laws or regulations of a foreign country that is comparable to 12 CFR 252.160–167. The laws or regulations of a foreign country are comparable to 12 CFR 252.160–167 if the requirement is imposed by a Financial Stability Board member state and those laws or regulations are substantially consistent with TLAC standards of the Financial Stability Board.

(vi) *Amounts paid or accrued in taxable years beginning before January 1, 2018.* Any amount paid or accrued in taxable years beginning before January 1, 2018.

(vii) *Business interest carried forward from taxable years beginning before January 1, 2018.* Any disallowed business interest described in section 163(j)(2) that is carried forward from a taxable year beginning before January 1, 2018.

(viii) *Specified nonrecognition transactions—(A) In general.* Subject to paragraph (b)(3)(viii)(B) and (C) of this section, any amount transferred to, or exchanged with, a foreign related party pursuant to a transaction to which sections 332, 351, 355, or 368 apply (“specified nonrecognition transaction”). See § 1.59A–9(b)(4) for anti-abuse rules.

(B) *Other property transferred to a foreign related party in a specified nonrecognition transaction.* If a taxpayer transfers other property (as defined in paragraph (b)(3)(viii)(D) of this section) to a foreign related party pursuant to a specified nonrecognition transaction, the other property is treated as an amount paid or accrued to which paragraph (b)(3) of this section does not apply, regardless of whether gain is recognized on the transaction.

(C) *Other property received from a foreign related party in certain specified nonrecognition transactions.* If, in a transaction described in section 351, 355, or 368, the taxpayer transfers property and receives other property (as defined in paragraph (b)(3)(viii)(D) of this section) from a foreign related

party, the property transferred by the taxpayer is treated as an amount paid or accrued to which paragraph (b)(3) of this section does not apply, regardless of whether gain is recognized on the transaction.

(D) *Definition of other property.* Solely for purposes of this paragraph (b)(3)(viii), the term *other property* has the meaning of the phrase “other property or money” as used in section 351(b), with respect to a transaction to which section 351 applies, and as used in sections 356(a)(1)(B) and 361(b), with respect to a transaction to which sections 355 or 368 apply, as applicable, including liabilities treated as money under section 357(b). However, the term *other property* does not include the sum of any money and the fair market value of any other property to which section 361(b)(3) applies. The term *other property* also includes liabilities that are assumed by the taxpayer in the specified nonrecognition transaction, but only to the extent of the amount of gain recognized under section 357(c).

(E) *Allocation of other property.* Other property is treated as exchanged for property in a specified nonrecognition transaction in a manner consistent with U.S. federal income tax law. For purposes making the allocation under this paragraph (b)(3)(viii)(E), liabilities described in paragraph (b)(3)(viii)(D) of this section are treated as money received.

(ix) *Reinsurance losses incurred and claims payments—(A) In general.* Any amounts paid by a taxpayer subject to tax under subchapter L to a foreign related party that is a regulated insurance company under a reinsurance contract between the taxpayer and the regulated foreign insurance company for losses incurred (as defined in section 832(b)(5)) and claims and benefits under section 805(a)(1), to the extent that the amounts paid or accrued are properly allocable to amounts required to be paid by the regulated foreign insurance company (or indirectly through another regulated foreign insurance company), pursuant to an insurance, annuity, or reinsurance contract, to a person other than a related party. For purposes of this paragraph (b)(3)(ix), the determination of whether a contract is an insurance contract or an annuity contract is made without regard to sections 72(s), 101(f), 817(h), and 7702, provided that the contract is regulated as a life insurance or annuity contract in its jurisdiction of issuance and no policyholder, insured, annuitant or beneficiary with respect to the contract is a United States person.

(B) *Regulated foreign insurance company.* The term regulated foreign

insurance company means any foreign corporation which—

(1) Is subject to regulation as an insurance (or reinsurance) company by the country in which the corporation is created, organized, or maintains its registered office, and is licensed, authorized, or regulated by the applicable insurance regulatory body for that country to sell insurance, annuity, or reinsurance contracts to persons other than related parties in that country, and

(2) Would be subject to tax under subchapter L if it were a domestic corporation.

(4) *Rules for determining the amount of certain base erosion payments.* The following rules apply in determining the amount that is a base erosion payment.

(i) *Interest expense allocable to a foreign corporation's effectively connected income—(A) Methods described in § 1.882–5.* A foreign corporation that has interest expense allocable under section 882(c) to income that is, or is treated as, effectively connected with the conduct of a trade or business within the United States applying the method described in § 1.882–5(b) through (d) or the method described in § 1.882–5(e) has base erosion payments under paragraph (b)(1)(i) of this section for the taxable year equal to the sum of—

(1) The interest expense on a liability described in § 1.882–5(a)(1)(ii)(A) or (B) (direct allocations) that is paid or accrued by the foreign corporation to a foreign related party;

(2) The interest expense on U.S.-booked liabilities, as described in § 1.882–5(d)(2), determined by taking into account paragraph (b)(4)(i)(B) of this section, that is paid or accrued by the foreign corporation to a foreign related party; and

(3) The interest expense on U.S.-connected liabilities, as described in § 1.882–5(d) or 1.882–5(e), in excess of interest expense on U.S.-booked liabilities as described in § 1.882–5(d)(2), if any (hereafter, excess U.S.-connected liabilities), multiplied by a fraction, 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. The numerator and denominator of this fraction are determined by translating interest expense into the functional currency of the foreign corporation using any reasonable method, consistently applied. Any interest expense that is interest expense on a U.S.-booked liability or is subject to a direct allocation is excluded from both

the numerator and the denominator of the fraction.

(B) *U.S.-booked liabilities determination.* For purposes of paragraph (b)(4)(i)(A) of this section, the determination of the interest expense on U.S.-booked liabilities, as described in § 1.882-5(d)(2), is made without regard to whether the foreign corporation applies the method described in § 1.882-5(b) through (d) or the method described in § 1.882-5(e) for purposes of determining interest expense.

(C) *U.S.-booked liabilities in excess of U.S.-connected liabilities.* For purposes of paragraph (b)(4)(i)(A)(2) of this section, if a foreign corporation has U.S.-booked liabilities, as described in § 1.882-5(d)(2), in excess of U.S.-connected liabilities, as described in § 1.882-5(d) or § 1.882-5(e), the foreign corporation applies the scaling ratio pro-rata to all interest expense on U.S.-booked liabilities consistent with § 1.882-5(d)(4) for purposes of determining the amount of allocable interest expense on U.S.-booked liabilities that is a base erosion payment. This paragraph (b)(4)(i)(C) applies without regard to whether the foreign corporation applies the method described in § 1.882-5(b) through (d) or the method described in § 1.882-5(e) for purposes of determining its interest expense.

(D) *Election to use financial statements.* A foreign corporation may elect to calculate the fraction described in paragraph (b)(4)(i)(A)(3) of this section on the basis of its applicable financial statement rather than U.S. tax principles. For purposes of this section, an applicable financial statement has the meaning provided in section 451(b)(3). The applicable financial statement must be the applicable financial statement of the foreign corporation, not a consolidated applicable financial statement. A foreign corporation makes this election in accordance with the requirements of Form 8991 (or successor).

(E) *Coordination with certain tax treaties—(1) In general.* If a foreign corporation elects to determine its taxable income pursuant to business profits provisions of an income tax treaty rather than provisions of the Internal Revenue Code, or the regulations published under 26 CFR chapter I, for determining effectively connected income, and the foreign corporation does not apply § 1.882-5 to allocate interest expense to a permanent establishment, then paragraph (b)(4)(i)(A) through (D) of this section applies to determine the amount of hypothetical § 1.882-5 interest expense that is a base erosion payment under

paragraph (b)(1) of this section. Interest expense allowed to the permanent establishment in excess of the hypothetical § 1.882-5 interest expense, if any, is treated as an amount paid or accrued by the permanent establishment to the foreign corporation's home office or to another branch of the foreign corporation and is a base erosion payment to the extent that the payment or accrual is described under paragraph (b)(1) of this section.

(2) *Hypothetical § 1.882-5 interest expense defined.* The hypothetical § 1.882-5 interest expense is equal to the amount of interest expense that would have been allocable under section 882(c) to income that is, or is treated as, effectively connected with the conduct of a trade or business within the United States if the foreign corporation determined interest expense in accordance with section § 1.882-5. However, the hypothetical § 1.882-5 interest expense shall not exceed the amount of interest expense allowed to the permanent establishment.

(3) *Consistency requirement.* For purposes of determining the amount described in paragraph (b)(4)(i)(E)(2) of this section and applying paragraph (b)(4)(i)(A) through (D) of this section, the elections of § 1.882-5 must be applied consistently and are subject to the rules and limitations of § 1.882-5, including limitations on the time period in which an election may be made or revoked. If a foreign corporation otherwise meets the requirements for making or revoking an election under § 1.882-5, then solely for purposes of this section, the foreign corporation is treated as making or revoking the election in accordance with the requirements of Form 8991 (or successor) and its instructions.

(F) *Coordination with exception for foreign TLAC securities.* For purposes of paragraph (b)(4)(i)(A) of this section, amounts paid or accrued to a foreign related party with respect to securities that are eligible for the foreign TLAC exception in paragraph (b)(3)(v) of this section are not treated as paid to a foreign related party.

(ii) *Other deductions allowed with respect to effectively connected income.* A deduction allowed under § 1.882-4 for an amount paid or accrued by a foreign corporation to a foreign related party (including a deduction for an amount apportioned in part to effectively connected income and in part to income that is not effectively connected income) is a base erosion payment under paragraph (b)(1) of this section.

(iii) *Depreciable property.* Any amount paid or accrued by a foreign

corporation to a foreign related party of the taxpayer in connection with the acquisition of property by the foreign corporation from the foreign related party if the character of the property is subject to the allowance for depreciation (or amortization in lieu of depreciation) is a base erosion payment to the extent the property so acquired is used, or held for use, in the conduct of a trade or business within the United States.

(iv) *Coordination with ECI exception.* For purposes of paragraph (b)(4) of this section, amounts paid or accrued to a foreign related party treated as effectively connected income (or, in the case of a foreign related party that determines taxable income pursuant to the business profits provisions of an applicable income tax treaty, such amounts that are taken into account in determining taxable income) are not treated as paid to a foreign related party.

(v) *Coordination with certain tax treaties—(A) Allocable expenses.* Except as provided in paragraph (b)(4)(i)(E) of this section with respect to interest, if a foreign corporation determines its taxable income on a net basis pursuant to an applicable income tax treaty rather than provisions of the Internal Revenue Code, or the regulations published under 26 CFR chapter I, for determining effectively connected income, then the foreign corporation must determine whether each allowable deduction is a base erosion payment under paragraph (b)(1) of this section.

(B) *Internal dealings under certain income tax treaties.* Except as provided in paragraph (b)(4)(i)(E) of this section with respect to interest, if, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the permanent establishment to the foreign corporation's home office or to another branch of the foreign corporation (an "internal dealing") is a base erosion payment to the extent that the payment or accrual is described under paragraph (b)(1) of this section.

(vi) *Business interest expense arising in taxable years beginning after December 31, 2017.* Any disallowed business interest expense described in section 163(j)(2) that resulted from a payment or accrual to a foreign related party that first arose in a taxable year beginning after December 31, 2017, is treated as a base erosion payment under paragraph (b)(1)(i) of this section in the year that the business interest expense

initially arose. See paragraph (c)(4) of this section for rules that apply when business interest expense is limited under section 163(j)(1) in order to determine whether the disallowed business interest is attributed to business interest expense paid to a person that is not a related party, a foreign related party, or a domestic related party.

(c) *Base erosion tax benefit*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, a base erosion tax benefit means:

(i) In the case of a base erosion payment described in paragraph (b)(1)(i) of this section, any deduction that is allowed under chapter 1 of subtitle A of the Internal Revenue Code for the taxable year with respect to that base erosion payment;

(ii) In the case of a base erosion payment described in paragraph (b)(1)(ii) of this section, any deduction allowed under chapter 1 of subtitle A of the Internal Revenue Code for the taxable year for depreciation (or amortization in lieu of depreciation) with respect to the property acquired with that payment;

(iii) In the case of a base erosion payment described in paragraph (b)(1)(iii) of this section, any reduction under section 803(a)(1)(B) in the gross amount of premiums and other consideration on insurance and annuity contracts for premiums and other consideration arising out of indemnity reinsurance, or any deduction under section 832(b)(4)(A) from the amount of gross premiums written on insurance contracts during the taxable year for premiums paid for reinsurance; or

(iv) In the case of a base erosion payment described in paragraph (b)(1)(iv) of this section, any reduction in gross receipts with respect to the payment in computing gross income of the taxpayer for the taxable year for purposes of chapter 1 of subtitle A of the Internal Revenue Code.

(2) *Exception to base erosion tax benefit*—(i) *In general.* Except as provided in paragraph (c)(3) of this section, any base erosion tax benefit attributable to any base erosion payment is not taken into account as a base erosion tax benefit if tax is imposed on that payment under section 871 or 881, and the tax has been deducted and withheld under section 1441 or 1442. If a payment is taken into account for purposes of the fraction described in paragraph (b)(4)(i)(A)(3) of this section, and tax is imposed on the payment under section 871 or 881, and the tax has been deducted and withheld under section 1441 or 1442, the payment is

treated as not paid or accrued to a foreign related party.

(ii) *Branch-level interest tax.* Except as provided in paragraph (c)(3) of this section, any base erosion tax benefit of a foreign corporation attributable to any base erosion payment determined under paragraph (b)(4)(i)(A)(3) of this section or attributable to interest expense in excess of the hypothetical section 1.882–5 interest expense determined under paragraph (b)(4)(i)(E)(1) of this section is not taken into account as a base erosion tax benefit to the extent of the amount of excess interest, as defined in § 1.884–4(a)(2), if any, on which tax is imposed on the foreign corporation under section 884(f) and § 1.884–4, if the tax is properly reported on the foreign corporation's income tax return and paid in accordance with § 1.884–4(a)(2)(iv).

(3) *Effect of treaty on base erosion tax benefit.* If any treaty between the United States and any foreign country reduces the rate of tax imposed by section 871 or 881, the amount of base erosion tax benefit that is not taken into account under paragraph (c)(2) of this section is equal to the amount of the base erosion tax benefit before the application of paragraph (c)(2) of this section multiplied by a fraction of—

(i) The rate of tax imposed under the treaty; over

(ii) The rate of tax imposed without regard to the treaty.

(4) *Application of section 163(j) to base erosion payments*—(i) *Classification of payments or accruals of business interest expense based on the payee.* The following rules apply for corporations and partnerships:

(A) *Classification of payments or accruals of business interest expense of a corporation.* For purposes of this section, in the year that business interest expense of a corporation is paid or accrued the business interest expense is classified as foreign related business interest expense, domestic related business interest expense, or unrelated business interest expense.

(B) *Classification of payments or accruals of business interest expense by a partnership.* For purposes of this section, in the year that business interest expense of a partnership is paid or accrued, the business interest expense that is allocated to a partner is classified separately with respect to each partner in the partnership as foreign related business interest expense, domestic related business interest expense, or unrelated business interest expense.

(C) *Classification of payments or accruals of business interest expense paid or accrued to a foreign related*

*party that is subject to an exception*—(1) *ECI exception.* For purposes of paragraph (c)(4)(i)(A) and (B) of this section, business interest expense paid or accrued to a foreign related party to which the exception in paragraph (b)(3)(iii) of this section (effectively connected income) applies is classified as domestic related business interest expense.

(2) *TLAC interest and interest subject to withholding tax.* For purposes of paragraph (c)(4)(i)(A) and (B) of this section, if the exception in paragraph (b)(3)(v) of this section (TLAC securities) or paragraph (c)(2) or (3) of this section (withholding tax) applies to business interest expense paid or accrued to a foreign related party, that business interest expense remains classified as foreign related business interest expense, and retains its classification as eligible for those exceptions, on a pro-rata basis with other foreign related business interest expense.

(ii) *Ordering rules for business interest expense that is limited under section 163(j)(1) to determine which classifications of business interest expense are deducted and which classifications of business interest expense are carried forward*—(A) *In general.* Section 163(j) and the regulations published under 26 CFR chapter I provide a limitation on the amount of business interest expense allowed as a deduction in a taxable year by a corporation or a partner in a partnership. In the case of a corporation with a disallowed business interest expense carryforward, the regulations under section 163(j) determine the ordering of the business interest expense deduction that is allowed on a year-by-year basis by reference first to business interest expense incurred in the current taxable year and then to disallowed business interest expense carryforwards from prior years. To determine the amount of base erosion tax benefit under paragraph (c)(1) of this section, this paragraph (c)(4)(ii) sets forth ordering rules that determine the amount of the deduction of business interest expense allowed under section 163(j) that is classified as paid or accrued to a foreign related party for purposes of paragraph (c)(1)(i) of this section. This paragraph (c)(4)(ii) also sets forth similar ordering rules that apply to disallowed business interest expense carryforwards for which a deduction is permitted under section 163(j) in a later year.

(B) *Ordering rules for treating business interest expense deduction and disallowed business interest expense carryforwards as foreign related*

*business interest expense, domestic related business interest expense, and unrelated business interest expense—(1) General ordering rule for allocating business interest expense deduction between classifications.* For purposes of paragraph (c)(1) of this section, if a deduction for business interest expense is not subject to the limitation under section 163(j)(1) in a taxable year, the deduction is treated first as foreign related business interest expense and domestic related business interest expense (on a pro-rata basis), and second as unrelated business interest expense. The same principle applies to business interest expense of a partnership that is deductible at the partner level under § 1.163(j)–6(f).

(2) *Ordering of business interest expense incurred by a corporation.* If a corporation's business interest expense deduction allowed for any taxable year is attributable to business interest expense paid or accrued in that taxable year and to disallowed business interest expense carryforwards from prior taxable years, the ordering of business interest expense deduction provided in paragraph (c)(4)(ii)(B)(1) of this section among the classifications described therein applies separately for the carryforward amount from each taxable year, following the ordering set forth in § 1.163(j)–5(b)(2). Corresponding adjustments to the classification of disallowed business interest expense carryforwards are made consistent with this year-by-year approach. For purposes of section 59A and this section, an acquiring corporation in a transaction described in section 381(a) will succeed to and take into account the classification of any disallowed business interest expense carryforward. See § 1.381(c)(20)–1.

(3) *Ordering of business interest expense incurred by a partnership and allocated to a corporate partner.* For a corporate partner in a partnership that is allocated a business interest expense deduction under § 1.163(j)–6(f), the ordering rule provided in paragraph (c)(4)(ii)(B)(1) of this section applies separately to the corporate partner's allocated business interest expense deduction from the partnership; that deduction is not comingled with the business interest expense deduction addressed in paragraph (c)(4)(ii)(B)(1) or (2) of this section or the corporate partner's items from any other partnership. Similarly, when a corporate partner in a partnership is allocated excess business interest expense from a partnership under the rules set forth in § 1.163(j)–6(f) and the excess interest expense becomes deductible to the corporate partner, that partner applies

the ordering rule provided in paragraph (c)(4)(ii)(B)(1) of this section separately to that excess interest expense on a year-by-year basis. Corresponding adjustments to the classification of disallowed business interest expense carryforwards are made consistent with this year-by-year and partnership-by-partnership approach.

(d) *Examples.* The following examples illustrate the application of this section. For purposes of all the examples, assume that the taxpayer is an applicable taxpayer and all payments apply to a taxable year beginning after December 31, 2017.

(1) *Example 1: Determining a base erosion payment—(i) Facts.* FP is a foreign corporation that owns all of the stock of FC, a foreign corporation, and DC, a domestic corporation. FP has a trade or business in the United States with effectively connected income (USTB). DC owns FDE, a foreign disregarded entity. DC pays interest to FDE and FC. FDE pays interest to USTB. All interest paid by DC to FC and by FDE to USTB is deductible by DC in the current year for regular income tax purposes. FDE also acquires depreciable property from FP during the taxable year. FP's income from the sale of the depreciable property is not effectively connected with the conduct of FP's trade or business in the United States. DC and FP (based only on the activities of USTB) are applicable taxpayers under § 1.59A–2(b).

(ii) *Analysis.* The payment of interest by DC to FC is a base erosion payment under paragraph (b)(1)(i) of this section because the payment is made to a foreign related party and the interest payment is deductible. The payment of interest by DC to FDE is not a base erosion payment because the transaction is not a payment to a foreign person and the transaction is not a deductible payment. With respect to the payment of interest by FDE to USTB, if FP's USTB treats the payment of interest by FDE to USTB as income that is effectively connected with the conduct of a trade or business in the United States pursuant to section 864 or as profits attributable to a U.S. permanent establishment of a tax treaty resident, and if DC receives a withholding certificate from FP with respect to the payment, then the exception in paragraph (b)(3)(iii) of this section applies. Accordingly, the payment from DC, through FDE, to USTB is not a base erosion payment even though the payment is to the USTB of FP, a foreign related party. The acquisition of depreciable property by DC, through FDE, from FP is a base erosion payment under paragraph (b)(1)(ii) of this section because there is a payment to a foreign related party in connection with the acquisition by the taxpayer of property of a character subject to the allowance for depreciation and the exception in paragraph (b)(3)(iii) of this section does not apply because FP's income from the sale of the depreciable property is not effectively connected with the conduct of FP's trade or business in the United States. See § 1.59A–2 for the application of the aggregation rule with respect to DC and FP's USTB.

(2) *Example 2: Interest allocable under § 1.882–5—(i) Facts.* FC, a foreign corporation, has income that is effectively connected with the conduct of a trade or business within the United States. FC determines its interest expense under the three-step process described in § 1.882–5(b) through (d) with a total interest expense of \$125x. The total interest expense is comprised of interest expense of \$100x on U.S.-booked liabilities (\$60x paid to a foreign related party and \$40x paid to unrelated persons) and \$25x of interest on excess U.S.-connected liabilities. FC has average worldwide interest expense (not including interest expense on U.S.-booked liabilities) of \$500x, of which \$100x is interest expense paid to a foreign related party. FC is an applicable taxpayer with respect to its effectively connected income. Assume all of the interest expense is deductible in the current taxable year and that none of the interest is subject to the effectively connected income exception in paragraph (b)(3)(iii) of this section.

(ii) *Analysis.* Under paragraph (b)(4)(i) of this section, the total amount of interest expense determined under § 1.882–5 that is a base erosion payment is \$65x (\$60x + 5x). FC has \$60x of interest on U.S.-booked liabilities that is paid to a foreign related party and that is treated as a base erosion payment under paragraph (b)(4)(i)(A)(2) of this section. Additionally, \$5x of the \$25x of interest expense on excess U.S.-connected liabilities is treated as a base erosion payment under paragraph (b)(4)(i)(A)(3) of this section (\$25x \* (\$100x/\$500x)).

(3) *Example 3: Interaction with section 163(j)—(i) Facts.* Foreign Parent (FP) is a foreign corporation that owns all of the stock of DC, a domestic corporation that is an applicable taxpayer. DC does not conduct a utility trade or business as described in section 163(j)(7)(A)(iv), an electing real property trade or business as described in section 163(j)(7)(B), or an electing farming business as described in section 163(j)(7)(C). In Year 1, DC has adjusted taxable income, as defined in section 163(j)(8), of \$1000x and pays the following amounts of business interest expense: \$420x that is paid to unrelated Bank, and \$360x that is paid to FP. DC does not earn any business interest income or incur any floor plan financing interest expense in Year 1. None of the exceptions in paragraph (b)(3) of this section apply, and the interest is not subject to withholding.

(ii) *Analysis—(A) Classification of business interest.* In Year 1, DC is permitted to deduct only \$300x of business interest expense under section 163(j)(1) (\$1000x × 30%). Paragraph (c)(4)(ii)(B) of this section provides that for purposes of paragraph (c)(1) of this section the deduction is treated first as foreign related business interest expense and domestic related business interest expense (here, only FP); and second as unrelated business interest expense (Bank). As a result, the \$300x of business interest expense that is permitted under section 163(j)(1) is treated entirely as the business interest paid to the related foreign party, FP. All of DC's \$300x deductible interest is treated as an add-back to modified taxable income in the Year 1

taxable year for purposes of § 1.59A–4(b)(2)(i).

(B) *Ordering rules for disallowed business interest expense carryforward.* Under section 163(j)(2), the \$480x of disallowed business interest (\$420x + \$360x – \$300x) is carried forward to the subsequent year. Under paragraph (c)(4)(ii)(B)(1) and (2) of this section, the disallowed business interest carryforward is correspondingly treated first as unrelated business interest expense, and second pro-rata as foreign related business interest expense and domestic related business interest expense. As a result, \$420x of the \$480x disallowed business interest expense carryforward is treated first as business interest expense paid to Bank and the remaining \$60x of the \$480x disallowed business interest expense carryforward is treated as interest paid to FP and as an add-back to modified taxable income.

(4) *Example 4: Interaction with section 163(j); carryforward—(i) Facts.* The facts are the same as in paragraph (d)(3) of this section (the facts in *Example 3*), except that in addition, in Year 2, DC has adjusted taxable income of \$250x, and pays the following amounts of business interest expense: \$50x that is paid to unrelated Bank, and \$45x that is paid to FP. DC does not earn any business interest income or incur any floor plan financing interest expense in Year 2. None of the exceptions in paragraph (b)(3) of this section apply.

(ii) *Analysis—(A) Classification of business interest.* In Year 2, for purposes of section 163(j)(1), DC is treated as having paid or accrued total business interest expense of \$575x, consisting of \$95x business interest expense actually paid in Year 2 and \$480x of business interest expense that is carried forward from Year 1. DC is permitted to deduct \$75x of business interest expense in Year 2 under the limitation in section 163(j)(1) (\$250x × 30%). Section 1.163(j)–5(b)(2) provides that, for purposes of section 163(j), the allowable business interest expense is first attributed to amounts paid or accrued in the current year, and then attributed to amounts carried over from earlier years on a first-in-first-out basis from the earliest year. Accordingly, the \$75x of deductible business interest expense is deducted entirely from the \$95x business interest expense incurred in Year 2 for section 163(j) purposes. Because DC's business interest expense deduction is limited under section 163(j)(1) and because DC's total business interest expense is attributable to more than one taxable year, paragraph (c)(4)(ii)(B)(2) of this section provides that the ordering rule in paragraph (c)(4)(ii)(B)(1) of this section is applied separately to each annual amount of section 163(j) disallowed business interest expense carryforward. With respect to the Year 2 layer, which is deducted first, paragraph (c)(4)(ii)(B) of this section provides that, for purposes of paragraph (c)(1) of this section, the Year 2 \$75x deduction is treated first as foreign related business interest expense and domestic related business interest expense (here, only FP, \$45x); and second as unrelated business interest expense (Bank, \$30x). Consequentially, all of the \$45x deduction of business interest expense that

was paid to FP in Year 2 is treated as a base erosion tax benefit and an add-back to modified taxable income for the Year 2 taxable year for purposes of § 1.59A–4(b)(2)(i).

(B) *Ordering rules for disallowed business interest expense carryforward.* The disallowed business interest expense carryforward of \$20x from Year 2 is correspondingly treated first as business interest expense paid to Bank under paragraph (c)(4)(i) of this section. The disallowed business interest expense carryforward of \$480x from the Year 1 layer that is also not allowed as a deduction in Year 2 remains treated as \$420x paid to Bank and \$60 paid to FP.

(5) *Example 5: Interaction with section 163(j); carryforward—(i) Facts.* The facts are the same as in paragraph (d)(4) of this section (the facts in *Example 4*), except that in addition, in Year 3, DC has adjusted taxable income of \$4000x and pays no business interest expense. DC does not earn any business interest income or incur any floor plan financing interest expense in Year 3.

(ii) *Analysis.* In Year 3, DC is treated as having paid or accrued total business interest expense of \$500x, consisting of \$480x of business interest expense that is carried forward from Year 1 and \$20x of business interest expense that is carried forward from Year 2 for purposes of section 163(j)(1). DC is permitted to deduct \$1200x of business interest expense in Year 3 under the limitation in section 163(j)(1) (\$4000x × 30%). For purposes of section 163(j), DC is treated as first deducting the business interest expense from Year 1 then the business interest expense from Year 2. See § 1.163(j)–5(b)(2). Because none of DC's \$500x business interest expense is limited under section 163(j), the stacking rule in paragraph (c)(4)(ii) of this section for allowed and disallowed business interest expense does not apply. For purposes of § 1.59A–4(b)(2)(i), DC's add-back to modified taxable income is \$60x determined by the classifications in paragraph (c)(4)(i)(A) of this section (\$60x treated as paid to FP from Year 1).

(6) *Example 6: Interaction with section 163(j); partnership—(i) Facts.* The facts are the same as in paragraph (d)(4) of this section (the facts in *Example 4*), except that in addition, in Year 2, DC forms a domestic partnership (PRS) with Y, a domestic corporation that is not related to DC within the meaning of § 1.59A–1(b)(17). PRS does not conduct a utility trade or business as described in section 163(j)(7)(A)(iv), an electing real property trade or business as described in section 163(j)(7)(B) or an electing farming business as described in section 163(j)(7)(C) subject to section 163(j). PRS is not a small business described in section 163(j)(3). DC and Y are equal partners in partnership PRS. In Year 2, PRS has ATI of \$100x and \$48x of business interest expense. \$12x of PRS's business interest expense is paid to Bank, and \$36x of PRS's business interest expense is paid to FP. PRS allocates the items comprising its \$100x of ATI \$50x to DC and \$50x to Y. PRS allocates its \$48x of business interest expense \$24x to DC and \$24x to Y. DC classifies its \$24x of

business interest expense as \$6x unrelated business interest expense (Bank) and \$18x as foreign related business interest expense (FP) under paragraph (c)(4)(i)(B) of this section. Y classifies its \$24x of business interest expense as entirely unrelated business interest expense of Y (Bank and FP) under paragraph (c)(4)(i)(B) of this section. None of the exceptions in paragraph (b)(3) of this section apply.

(ii) *Partnership level analysis.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI, or \$30x (\$100x × 30 percent). Thus, PRS has \$30x of deductible business interest expense and \$18x of excess business interest expense (\$48x – \$30x). The \$30x of deductible business interest expense is includible in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner level allocations analysis.* Pursuant to § 1.163(j)–6(f)(2), DC and Y are each allocated \$15x of deductible business interest expense and \$9x of excess business interest expense. At the end of Year 2, DC and Y each have \$9x of excess business interest expense from PRS, which under § 1.163(j)–6 is not treated as paid or accrued by the partner until such partner is allocated excess taxable income or excess business interest income from PRS in a succeeding year. Pursuant to § 1.163(j)–6(e), DC and Y, in computing their limit under section 163(j), do not increase any of their section 163(j) items by any of PRS's section 163(j) items.

(iv) *Partner level allocations for determining base erosion tax benefits.* The \$15x of deductible business interest expense allocated to DC is treated first as foreign related business interest expense (FP) under paragraph (c)(4)(ii)(B) of this section. DC's excess business interest expense from PRS of \$9x is classified first as the unrelated business interest expense with respect to Bank (\$6x) and then as the remaining portion of the business interest expense paid to FP (\$3x, or \$18x – \$15x). Under paragraph (c)(4)(ii)(B)(3) of this section, these classifications of the PRS items apply irrespective of the classifications of DC's own interest expense as set forth in paragraph (d)(4) of this section (*Example 4*).

(v) *Computation of modified taxable income.* For Year 2, DC is treated as having incurred base erosion tax benefits of \$60x, consisting of the \$15x base erosion tax benefit with respect to its interest in PRS that is computed in paragraph (d)(6)(iii) of this section (*Example 6*) and \$45x that is computed in paragraph (d)(4) of this section (*Example 4*).

(7) *Example 7: Transfers of property to related taxpayers—(i) Facts.* FP is a foreign corporation that owns all of the stock of DC1 and DC2, both domestic corporations. DC1 and DC2 are both members of the same aggregate group but are not members of the same consolidated tax group under section 1502. In Year 1, FP sells depreciable property to DC1. On the first day of the Year 2 tax year, DC1 sells the depreciable property to DC2.

(ii) *Analysis—(A) Year 1.* The acquisition of depreciable property by DC1 from FP is a base erosion payment under paragraph

(b)(1)(ii) of this section because there is a payment to a foreign related party in connection with the acquisition by the taxpayer of property of a character subject to the allowance for depreciation.

(B) *Year 2.* The acquisition of the depreciable property in Year 2 by DC2 is not itself a base erosion payment because DC2 did not acquire the property from a foreign related party. However, under paragraph (b)(2)(viii) of this section any depreciation expense taken by DC2 on the property acquired from DC1 is a base erosion payment and a base erosion tax benefit under paragraph (c)(1)(ii) of this section because the acquisition of the depreciable property was a base erosion payment by DC1 and the property was sold to a member of the aggregate group; therefore, the depreciation expense continues as a base erosion tax benefit to DC2 as it would have been to DC1 if it continued to own the property.

#### **§ 1.59A-4 Modified taxable income.**

(a) *Scope.* Paragraph (b)(1) of this section provides rules for computing modified taxable income. Paragraph (b)(2) of this section provides rules addressing how base erosion tax benefits and net operating losses affect modified taxable income. Paragraph (b)(3) of this section provides a rule for a holder of a residual interest in a REMIC. Paragraph (c) of this section provides examples illustrating the rules described in this section.

(b) *Computation of modified taxable income—(1) In general.* The term *modified taxable income* means a taxpayer's taxable income, as defined in section 63(a), determined with the additions described in paragraph (b)(2) of this section. Notwithstanding the foregoing, the taxpayer's taxable income may not be reduced to an amount less than zero as a result of a net operating loss deduction allowed under section 172. See paragraphs (c)(1) and (2) of this section (*Examples 1 and 2*).

(2) *Modifications to taxable income.* The amounts described in this paragraph (b)(2) are added back to a taxpayer's taxable income to determine its modified taxable income.

(i) *Base erosion tax benefits.* The amount of any base erosion tax benefit as defined in § 1.59A-3(c)(1).

(ii) *Certain net operating loss deductions.* The base erosion percentage, as described in § 1.59A-2(e)(3), of any net operating loss deduction allowed to the taxpayer under section 172 for the taxable year. For purposes of determining modified taxable income, the net operating loss deduction allowed does not exceed taxable income before taking into account the net operating loss deduction. See paragraph (c)(1) and (2) of this section (*Examples 1 and 2*). The base erosion percentage for the taxable

year that the net operating loss arose is used to determine the addition under this paragraph (b)(2)(ii). For a net operating loss that arose in a taxable year beginning before January 1, 2018, the base erosion percentage for the taxable year is zero.

(3) *Rule for holders of a residual interest in a REMIC.* For purposes of paragraph (b)(1) of this section, the limitation in section 860E(a)(1) is not taken into account in determining the taxable income amount that is used to compute modified taxable income for the taxable year.

(c) *Examples.* The following examples illustrate the rules of paragraph (b) of this section.

(1) *Example 1: Current year loss—(i) Facts.* A domestic corporation (DC) is an applicable taxpayer that has a calendar taxable year. In 2020, DC has gross income of \$100x, a deduction of \$80x that is not a base erosion tax benefit, and a deduction of \$70x that is a base erosion tax benefit. In addition, DC has a net operating loss carryforward to 2020 of \$400x that arose in 2016.

(ii) *Analysis.* DC's starting point for computing modified taxable income is \$(50x), computed as gross income of \$100x, less a deduction of \$80x (non-base erosion tax benefit) and a deduction of \$70x (base erosion tax benefit). Under paragraph (b)(2)(ii) of this section, DC's starting point for computing modified taxable income does not take into account the \$400x net operating loss carryforward because the allowable deductions for 2020, not counting the NOL deduction, exceed the gross income for 2020. DC's modified taxable income for 2020 is \$20x, computed as \$(50x) + \$70x base erosion tax benefit.

(2) *Example 2: Net operating loss deduction—(i) Facts.* The facts are the same as in paragraph (c)(1)(i) of this section (the facts in *Example 1*), except that DC's gross income in 2020 is \$500x.

(ii) *Analysis.* DC's starting point for computing modified taxable income is \$0x, computed as gross income of \$500x, less: A deduction of \$80x (non-base erosion tax benefit), a deduction of \$70x (base erosion tax benefit), and a net operating loss deduction of \$350x (which is the amount of taxable income before taking into account the net operating loss deduction, as provided in paragraph (b)(2)(ii) of this section (\$500x - \$150x)). DC's modified taxable income for 2020 is \$70x, computed as \$0x + \$70x base erosion tax benefit. DC's modified taxable income is not increased as a result of the \$350x net operating loss deduction in 2020 because the base erosion percentage of the net operating loss that arose in 2016 is zero under paragraph (b)(2)(ii) of this section.

#### **§ 1.59A-5 Base erosion minimum tax amount.**

(a) *Scope.* Paragraph (b) of this section provides rules regarding the calculation of the base erosion minimum tax amount. Paragraph (c) of this section describes the base erosion and anti-

abuse tax rate applicable to the taxable year.

(b) *Base erosion minimum tax amount—(1) In general.* For each taxable year, an applicable taxpayer must determine its base erosion minimum tax amount.

(2) *Calculation of base erosion minimum tax amount.* With respect to any applicable taxpayer, the base erosion minimum tax amount for any taxable year is, the excess (if any) of—

(i) An amount equal to the base erosion and anti-abuse tax rate multiplied by the modified taxable income of the taxpayer for the taxable year, over

(ii) An amount equal to the regular tax liability as defined in § 1.59A-1(b)(16) of the taxpayer for the taxable year, reduced (but not below zero) by the excess (if any) of—

(A) The credits allowed under chapter 1 of subtitle A of the Code against regular tax liability over

(B) The sum of the credits described in paragraph (b)(3) of this section.

(3) *Credits that do not reduce regular tax liability.* The sum of the following credits are used in paragraph (b)(2)(ii)(B) of this section to limit the amount by which the credits allowed under chapter 1 of subtitle A of the Internal Revenue Code reduce regular tax liability—

(i) *Taxable years beginning on or before December 31, 2025.* For any taxable year beginning on or before December 31, 2025—

(A) The credit allowed under section 38 for the taxable year that is properly allocable to the research credit determined under section 41(a);

(B) The portion of the applicable section 38 credits not in excess of 80 percent of the lesser of the amount of those applicable section 38 credits or the base erosion minimum tax amount (determined without regard to this paragraph (b)(3)(i)(B)); and

(C) Any credits allowed under sections 33, 37, and 53.

(ii) *Taxable years beginning after December 31, 2025.* For any taxable year beginning after December 31, 2025, any credits allowed under sections 33, 37, and 53.

(c) *Base erosion and anti-abuse tax rate—(1) In general.* For purposes of calculating the base erosion minimum tax amount, the base erosion and anti-abuse tax rate is—

(i) *Calendar year 2018.* For taxable years beginning in calendar year 2018, five percent.

(ii) *Calendar years 2019 through 2025.* For taxable years beginning after December 31, 2018, through taxable



years beginning before January 1, 2026, 10 percent.

(iii) *Calendar years after 2025.* For taxable years beginning after December 31, 2025, 12.5 percent.

(2) *Increased rate for banks and registered securities dealers—(i) In general.* In the case of a taxpayer that is a member of an affiliated group (as defined in section 1504(a)(1)) that includes a bank or a registered securities dealer, the percentage otherwise in effect under paragraph (c)(1) of this section is increased by one percentage point.

(ii) *De minimis exception to increased rate for banks and registered securities dealers.* Paragraph (c)(2)(i) of this section does not apply to a taxpayer that is a member of an affiliated group (as defined in section 1504(a)(1)) that includes a bank or registered securities dealer if, in that taxable year, the total gross receipts of the affiliated group attributable to the bank or the registered securities dealer (or attributable to all of the banks and registered securities dealers in the group, if more than one) represent less than two percent of the total gross receipts of the affiliated group, as determined under § 1.59A–2(d).

(3) *Application of section 15 to tax rates in section 59A—(i) New tax.* Section 15 does not apply to any taxable year that includes January 1, 2018.

(ii) *Change in tax rate pursuant to section 59A(b)(1)(A).* Section 15 does not apply to any taxable year that includes January 1, 2019.

(iii) *Change in rate pursuant to section 59A(b)(2).* Section 15 applies to the change in tax rate pursuant to section 59A(b)(2)(A).

#### **§ 1.59A–6 Qualified derivative payment.**

(a) *Scope.* This section provides additional guidance regarding qualified derivative payments. Paragraph (b) of this section defines the term qualified derivative payment. Paragraph (c) of this section provides guidance on certain payments that are not treated as qualified derivative payments. Paragraph (d) defines the term derivative for purposes of section 59A. Paragraph (e) of this section provides examples illustrating the rules of this section.

(b) *Qualified derivative payment—(1) In general.* A qualified derivative payment means any payment made by a taxpayer to a foreign related party pursuant to a derivative with respect to which the taxpayer—

(i) Recognizes gain or loss as if the derivative were sold for its fair market value on the last business day of the taxable year (and any additional times

as required by the Internal Revenue Code or the taxpayer's method of accounting);

(ii) Treats any gain or loss so recognized as ordinary; and

(iii) Treats the character of all items of income, deduction, gain, or loss with respect to a payment pursuant to the derivative as ordinary.

(2) *Reporting requirements—(i) In general.* No payment is a qualified derivative payment under paragraph (b)(1) of this section for any taxable year unless the taxpayer (whether or not the taxpayer is a reporting corporation as defined in § 1.6038A–1(c)) reports the information required in § 1.6038A–2(b)(7)(ix) for the taxable year. To report its qualified derivative payments, a taxpayer must include the payment in the aggregate amount of qualified derivative payments on Form 8991 (or successor).

(ii) *Failure to satisfy the reporting requirement.* If a taxpayer fails to satisfy the reporting requirement described in paragraph (b)(2)(i) of this section with respect to any payments, those payments are not eligible for the qualified derivative payment exception described in § 1.59A–3(b)(3)(ii) and are base erosion payments unless an exception in § 1.59A–3(b)(3) otherwise applies. A taxpayer's failure to report a payment as a qualified derivative payment does not impact the eligibility of any other payment which the taxpayer properly reported under paragraph (b)(2)(i) of this section from being a qualified derivative payment.

(iii) *Reporting of aggregate amount of qualified derivative payments.* The aggregate amount of qualified derivative payments is the sum of the amount described in paragraph (b)(3) of this section for each derivative. To the extent that the taxpayer is treated as receiving a payment, as determined in § 1.59A–2(e)(3)(vi), for the taxable year with respect to a derivative, the payment is not included in the aggregate qualified derivative payments.

(iv) *Transition period for qualified derivative payment reporting.* Before paragraph (b)(2)(i) of this section is applicable, a taxpayer will be treated as satisfying the reporting requirement described section 59A(h)(2)(B) to the extent that the taxpayer reports the aggregate amount of qualified derivative payments on Form 8991 (or successor). See § 1.6038A–2(g) (applicability date for § 1.6038A–2(b)(7)(ix)). Until paragraph (b)(2)(i) of this section is applicable, paragraph (b)(2)(ii) of this section will not apply to a taxpayer who reports the aggregate amount of qualified derivative payments in good faith.

(3) *Amount of any qualified derivative payment—(i) In general.* The amount of any qualified derivative payment excluded from the denominator of the base erosion percentage as provided in § 1.59A–2(e)(3)(ii)(C) is determined as provided in § 1.59A–2(e)(3)(vi).

(ii) *Net qualified derivative payment that includes a payment that is a base erosion payment.* Any net amount determined in paragraph (b)(3)(i) of this section must be reduced by any gross items that are treated as a base erosion payment pursuant to paragraph (c) of this section.

(c) *Exceptions for payments otherwise treated as base erosion payments.* A payment does not constitute a qualified derivative payment if—

(1) The payment would be treated as a base erosion payment if it were not made pursuant to a derivative, including any interest, royalty, or service payment; or

(2) In the case of a contract that has derivative and nonderivative components, the payment is properly allocable to the nonderivative component.

(d) *Derivative defined—(1) In general.* For purposes of this section, the term *derivative* means any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

(i) Any share of stock in a corporation;  
(ii) Any evidence of indebtedness;  
(iii) Any commodity that is actively traded;  
(iv) Any currency; or  
(v) Any rate, price, amount, index, formula, or algorithm.

(2) *Exceptions.* The following contracts are not treated as derivatives for purposes of section 59A.

(i) *Direct interest.* A derivative contract does not include a direct interest in any item described in paragraph (d)(1)(i) through (v) of this section.

(ii) *Insurance contracts.* A derivative contract does not include any insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or issued by any foreign corporation to which the subchapter would apply if the foreign corporation were a domestic corporation).

(iii) *Securities lending and sale-repurchase transactions—(A) Multi-step transactions treated as financing.* For purposes of paragraph (d)(1) of this section, a derivative does not include any securities lending transaction, sale-



repurchase transaction, or substantially similar transaction that is treated as a secured loan for federal tax purposes. Securities lending transaction and sale-repurchase transaction have the meanings provided in § 1.861-2(a)(7).

(B) *Special rule for payments associated with the cash collateral provided in a securities lending transaction or substantially similar transaction.* For purposes of paragraph (d)(1) of this section, a derivative does not include the cash collateral component of a securities lending transaction (or the cash payments pursuant to a sale-repurchase transaction, or similar payments pursuant to a substantially similar transaction).

(C) *Anti-abuse exception for certain transactions that are the economic equivalent of substantially unsecured cash borrowing.* For purposes of paragraph (d)(1) of this section, a derivative does not include any securities lending transaction or substantially similar transaction that is part of an arrangement that has been entered into with a principal purpose of avoiding the treatment of any payment with respect to that transaction as a base erosion payment and that provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing. The determination of whether the securities lending transaction or substantially similar transaction provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing takes into account arrangements that effectively serve as collateral due to the taxpayer's compliance with any U.S. regulatory requirements governing such transaction.

(3) *American depository receipts.* For purposes of section 59A, American depository receipts (or any similar instruments) with respect to shares of stock in a foreign corporation are treated as shares of stock in that foreign corporation.

(e) *Examples.* The following examples illustrate the rules of this section.

(1) *Example 1: Notional principal contract as QDP—(i) Facts.* Domestic Corporation (DC) is a dealer in securities within the meaning of section 475. On February 1, 2019, DC enters into a contract (Interest Rate Swap) with Foreign Parent (FP), a foreign related party, for a term of five years. Under the Interest Rate Swap, DC is obligated to make a payment to FP each month, beginning March 1, 2019, in an amount equal to a variable rate determined by reference to the prime rate, as determined on the first business day of the immediately preceding month, multiplied by a notional principal amount of \$50x. Under the Interest Rate Swap, FP is obligated to make a payment to

DC each month, beginning March 1, 2019, in an amount equal to 5% multiplied by the same notional principal amount. The Interest Rate Swap satisfies the definition of a notional principal contract under § 1.446-3(c). DC recognizes gain or loss on the Interest Rate Swap pursuant to section 475. DC reports the information required to be reported for the taxable year under § 1.6038A-2(b)(7)(ix).

(ii) *Analysis.* The Interest Rate Swap is a derivative as described in paragraph (d) of this section because it is a contract that references the prime rate and a fixed rate for determining the amount of payments. The exceptions described in paragraph (c) of this section do not apply to the Interest Rate Swap. Because DC recognizes ordinary gain or loss on the Interest Rate Swap pursuant to section 475(d)(3), it satisfies the condition in paragraph (b)(1)(ii) of this section. Because DC satisfies the requirement relating to the information required to be reported under paragraph (b)(2) of this section, any payment to FP with respect to the Interest Rate Swap will be a qualified derivative payment. Therefore, under § 1.59A-3(b)(3)(ii), the payments to FP are not base erosion payments.

(2) *Example 2: Securities lending anti-abuse rule—(i) Facts.* (A) Foreign Parent (FP) is a foreign corporation that owns all of the stock of domestic corporation (DC) and foreign corporation (FC). FP and FC are foreign related parties of DC under § 1.59A-1(b)(12) but not members of DC's aggregate group. On January 1 of year 1, with a principal purpose of providing financing to DC without DC making a base erosion payment to FC, FC lends 100x U.S. Treasury bills with a remaining maturity of 11 months (Securities A) to DC (Securities Lending Transaction 1) for a period of six months. Pursuant to the terms of Securities Lending Transaction 1, DC is obligated to make substitute payments to FC corresponding to the interest payments on Securities A. DC does not post cash collateral with respect to Securities Lending Transaction 1, and no other arrangements of FC or DC effectively serve as collateral under any U.S. regulatory requirements governing the transaction. Immediately thereafter, DC sells Securities A for cash.

(B) On June 30 of year 1, FC lends 100x U.S. Treasury bills with a remaining maturity of 11 months (Securities B) to DC (Securities Lending Transaction 2) for a period of six months. Pursuant to the terms of Securities Lending Transaction 2, DC is obligated to make substitute payments to FC corresponding to the interest payments on Securities B. Immediately thereafter, DC sells Securities B for cash and uses the cash to purchase U.S. Treasury bills with a remaining maturity equal to the Securities A bills that DC then transfers to FC in repayment of Securities Lending Transaction 1.

(ii) *Analysis.* Securities Lending Transaction 1 and Securities Lending Transaction 2 are not treated as derivatives for purposes of paragraph (d)(1) of this section because the transactions are part of an arrangement that has been entered into with a principal purpose of avoiding the

treatment of any payment with respect to Securities Lending Transaction 1 and Securities Lending Transaction 2 as a base erosion payment and provides DC with the economic equivalent of a substantially unsecured cash borrowing by DC. As a result, pursuant to paragraph (d)(2)(iii)(C) of this section, the substitute payments made by DC to FC with respect to Securities A and Securities B are not eligible for the exception in § 1.59A-3(b)(3)(ii) (qualified derivative payment).

#### **§ 1.59A-7 Application of base erosion and anti-abuse tax to partnerships.**

(a) *Scope.* This section provides rules regarding how partnerships and their partners are treated for purposes of making certain determinations under section 59A, including whether there is a base erosion payment or base erosion tax benefit. All references to partnerships in this section include domestic and foreign partnerships. This section applies to payments to a partnership and payments from a partnership as well as transfers of partnership interests (as defined in paragraph (c)(3)(iv) of this section). The aggregate principle described in this section does not override the treatment of partnership items under any Code section other than section 59A. The aggregate principles provided in this section apply without regard to any tax avoidance purpose relating to a particular partnership. See § 1.701-2(e). Paragraph (b) of this section describes how the aggregate approach to partnerships applies for purposes of certain section 59A determinations. Paragraph (c) of this section provides rules for determining whether there is a base erosion payment with respect to a payment to or from a partnership. Paragraph (d) of this section provides rules for determining the base erosion tax benefits of a partner. Paragraph (e) of this section provides additional rules relating to the application of section 59A to partnerships. Paragraph (f) of this section provides a rule for determining whether a person is a foreign related party. Paragraph (g) of this section provides examples that illustrate the application of the rules of this section.

(b) *Application of section 59A to partnerships.* The purpose of this section is to provide a set of operating rules for the application of section 59A to partnerships and partners in a manner consistent with the purposes of section 59A. Except for purposes of determining a partner's base erosion tax benefits under paragraph (d)(1) of this section and whether a taxpayer is a registered securities dealer under paragraph (e)(3) of this section, section 59A determinations are made at the

partner level in the manner described in this section. The provisions of section 59A must be interpreted in a manner consistent with this approach. If a transaction is not specifically described in this section, whether the transaction gives rise to a base erosion payment or base erosion tax benefit is determined in accordance with the principles of this section and the purposes of section 59A.

(c) *Base erosion payment.* For purposes of determining whether a taxpayer has made a base erosion payment as described in § 1.59A–3(b), the taxpayer must treat a payment to or from a partnership as made to or from each partner and the assets and liabilities of the partnership as assets and liabilities of each partner. This paragraph (c) provides specific rules for determining whether a partner has made or received a payment, including as a result of a partnership interest transfer (as defined in paragraph (c)(3)(iv) of this section).

(1) *Payments made by or to a partnership.* For purposes of determining whether a payment or accrual by a partnership is a base erosion payment described in § 1.59A–3(b)(1)(i), any amount paid or accrued by the partnership (including any guaranteed payment described in section 707(c)) is treated as paid or accrued by each partner based on the partner's distributive share of the item of deduction with respect to that amount. For purposes of determining whether a payment or accrual to a partnership is a base erosion payment described in § 1.59A–3(b)(1)(ii) or (iii), any amount paid or accrued to the partnership (including any guaranteed payment described in section 707(c)) is treated as paid or accrued to each partner based on the partner's distributive share of the item of income with respect to that amount. See paragraph (e)(1) of this section to determine the partner's distributive share.

(2) *Transfers of certain property.* When a partnership transfers property, each partner is treated as transferring its proportionate share of the property transferred for purposes of determining whether there is a base erosion payment described in § 1.59A–3(b)(1)(ii) or (iv). When a partnership acquires property, each partner is treated as acquiring its proportionate share of the property acquired for purposes of determining whether there is a base erosion payment described in § 1.59A–3(b)(1)(ii) or (iv). For purposes of this paragraph (c)(2), a transfer of property does not include a transfer of a partnership interest (as defined in paragraph (c)(3)(iv) of this section). See paragraph (c)(3) of this

section for rules applicable to transfers of partnership interests. See paragraphs (g)(2)(v) and (vi) of this section (*Example 5* and *Example 6*) for examples illustrating the application of this paragraph (c)(2).

(3) *Transfers of a partnership interest—(i) In general.* A transfer of a partnership interest (as defined in paragraph (c)(3)(iv) of this section) is generally treated as a transfer by each partner in the partnership of its proportionate share of the partnership's assets to the extent of any change in its proportionate share of any partnership asset, as well as any assumption of associated liabilities by the partner. Paragraphs (c)(3)(ii) and (iii) of this section provide rules for applying the general rule to transfers of a partnership interest by a partner and issuances of a partnership interest by the partnership for contributed property, respectively. See paragraph (g)(2)(vii) of this section (*Example 7*) for an example illustrating the application of this paragraph (c)(3)(i).

(ii) *Transfers of a partnership interest by a partner.* A transfer of a partnership interest (as defined in paragraph (c)(3)(iv) of this section) by a partner is treated as a transfer by the transferor to the recipient of the transferor's proportionate share of each of the partnership assets and an assumption by the recipient of the transferor's proportionate share of the partnership liabilities. If the partner's entire partnership interest is not transferred, only the proportionate share of each of the partnership assets and liabilities associated with the transferred partnership interest is treated as transferred and assumed. See paragraphs (g)(2)(iii), (iv), and (vi) of this section (*Example 3*, *Example 4*, and *Example 6*) for examples illustrating the application of this paragraph (c)(3)(ii).

(iii) *Certain issuances of a partnership interest by a partnership.* If a partnership issues an interest in the partnership in exchange for a contribution of property to the partnership, the contributing partner is treated as exchanging a portion of the contributed property and assuming any liabilities associated with the transferred partnership interest for a portion of the partners' pre-contribution interests in the partnership's assets and the partners' assumption of any liabilities transferred to the partnership. For purposes of this paragraph (c)(3)(iii), a reference to the "partnership's assets" includes the assets contributed by the contributing partner and any other assets that are contributed to the partnership 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. For example, if a person contributes property to a partnership in which each of two existing partners has a 50 percent 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 their 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. See paragraphs (g)(2)(i) and (ii) of this section (*Example 1* and *Example 2*) for additional examples illustrating the application of this paragraph (c)(3)(iii).

(iv) *Partnership interest transfers defined.* For purposes of paragraphs (c)(3) and (4) of this section, a transfer of a partnership interest 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).

(4) *Increased basis from a distribution.* If a distribution of property from a partnership to a partner results in an increase in the tax basis of either the distributed property or other partnership property, such as under section 732(b) or 734(b), the increase in tax basis attributable to a foreign related party is treated as if it was newly purchased property acquired by the taxpayer (to the extent of its proportionate share) from the foreign related party that is placed in service when the distribution occurs. See § 1.734–1(e). This increased basis treated as newly purchased property is treated as acquired with a base erosion payment, unless an exception in § 1.59A–3(b) applies. For this purpose,

in the case of a distribution to a foreign related party, the increased basis in the remaining partnership property that is treated as newly purchased property is entirely attributable to the foreign related party. In the case of a distribution to a taxpayer, the increased basis in the distributed property that is treated as newly purchased property is attributable to each foreign related party in proportion to the foreign related party's proportionate share of the asset immediately before the distribution. 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 this paragraph (c)(4). See paragraphs (g)(2)(vii), (viii), and (ix) of this section (*Example 7*, *Example 8*, and *Example 9*) for examples illustrating the application of this paragraph (c)(4).

(5) *Operating rules applicable to base erosion payments*—(i) *Single payment characterized as separate transactions*. If a single transaction is partially characterized in one manner and partially characterized in another manner, each part of the transaction is separately analyzed. For example, if a contribution of property to a partnership is partially treated as a contribution and partially treated as a disguised sale, the contribution and sale are separately analyzed under paragraph (c) of this section.

(ii) *Ordering rule with respect to transfers of a partnership interest*. If a partnership interest is transferred (within the meaning of paragraph (c)(3)(iv) of this section), paragraph (c)(3) of this section first applies to determine the assets deemed transferred by the transferor(s) to the transferee(s) and liabilities deemed assumed by the parties. Then, to the extent applicable (such as where a partnership makes a contribution in exchange for an interest in another partnership or when a partnership receives an interest in another partnership as a contribution to it), paragraph (c)(2) of this section applies for purposes of determining the proportionate share of the property received by the partners in a partnership. See paragraph (g)(2)(vi) of this section (*Example 6*) for an illustration of this rule.

(iii) *Consideration for base erosion payment or property resulting in base erosion tax benefits*. When a partnership pays or receives property, services, or other consideration, each partner is deemed to pay or receive the property, services, or other consideration paid or received by the partnership for purposes of determining if there is a base erosion payment, except as otherwise provided in paragraph (c) of this section. See

paragraphs (g)(2)(v) and (vi) of this section (*Example 5* and *Example 6*) for illustrations of this rule.

(iv) *Non-cash consideration*. When both parties to a transaction use non-cash consideration, each party must separately apply paragraph (c) of this section to determine its base erosion payment with respect to each property. For example, if two partnerships, each with a domestic corporation and a foreign corporation as partners, all of whom are related, exchange depreciable property, each transfer of property would be separately analyzed to determine whether it is a base erosion payment.

(d) *Base erosion tax benefit for partners*—(1) *In general*. 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)) is the partner's base erosion tax benefit, subject to the exceptions in § 1.59A–3(c)(2). See paragraph (e)(1) of this section to determine the partner's distributive share for purposes of section 59A. A partner's base erosion tax benefit may be more than the partner's base erosion payment. For example, if a partnership makes a payment to a foreign related party of its domestic partner to acquire a depreciable asset, and the partnership specially allocates more depreciation deductions to a partner than its proportionate share of the asset, the partner's base erosion tax benefit 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. Base erosion tax benefits are determined separately for each asset, payment, or accrual, as applicable, and are not netted with other items. A taxpayer determines its base erosion tax benefits for non-partnership items pursuant to § 1.59A–3(c).

(2) *Exception for base erosion tax benefits of certain small partners*—(i) *In general*. For purposes of determining a partner's amount of base erosion tax benefits attributable to a base erosion payment made by a partnership, a partner does not take into account its distributive share of any base erosion tax benefits from the partnership for the taxable year if—

(A) The partner's interest in the partnership represents less than ten percent of the capital and profits of the partnership at all times during the taxable year;

(B) The partner is allocated less than ten percent of each partnership item of income, gain, loss, deduction, and credit for the taxable year; and

(C) The partner's interest in the partnership has a fair market value of less than \$25 million on the last day of the partner's taxable year, determined using a reasonable method.

(ii) *Attribution*. For purposes of paragraph (d)(2)(i) of this section, a partner's interest in a partnership or partnership item is determined by adding the interests of the partner and any related party of the partner (as determined under section 59A), taking into account any interest owned directly, indirectly, or through constructive ownership (applying the section 318 rules as modified by section 59A (except section 318(a)(3)(A) through (C)) will also apply so as to consider a United States person as owning stock that is owned by a person who is not a United States person), but excluding any interest to the extent already taken into account).

(e) *Other rules for applying section 59A to partnerships*—(1) *Partner's distributive share*. For purposes of section 59A, each partner's distributive share of an item of income or deduction of the partnership is determined under sections 704(b) and (c) and takes into account amounts determined under other provisions of the Code, including but not limited to sections 707(a) and (c), 732(b) and (d), 734(b) and (d), 737, 743(b) and (d), and 751(b). See § 1.704–1(b)(1)(iii) regarding the application of section 482. 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. For purposes of section 59A, a partner's distributive share of a reduction to determine gross income is equal to a proportionate amount of the partnership's reduction to determine gross income corresponding to the partner's share of the partnership gross receipts (as determined under paragraph (e)(2)(i) of this section) related to that reduction.

(2) *Gross receipts*—(i) *In general*. For purposes of section 59A, each partner in the partnership includes a share of partnership gross receipts in proportion to the partner's distributive share (as determined under sections 704(b) and (c)) of items of gross income that were taken into account by the partnership under section 703 or 704(c) (such as remedial or curative items under § 1.704–3(c) or (d)).

(ii) *Foreign corporation*. See § 1.59A–2(d)(2) for gross receipts of foreign corporations.

(3) *Registered securities dealers.* If a partnership, or a branch of the partnership, is a registered securities dealer, each partner is treated as a registered securities dealer unless the partner's interest in the registered securities dealer would satisfy the criteria for the exception in paragraph (d)(2) of this section. For purposes of applying the de minimis exception in § 1.59A-2(e)(2)(iii), a partner takes into account its distributive share of the relevant partnership items.

(4) *Application of sections 163(j) and 59A(c)(3) to partners.* See § 1.59A-3(c)(4).

(5) *Tiered partnerships.* In the case of one or more partnerships owning an interest in another partnership (or partnerships), the rules of this section apply successively to each partnership and its partners in the chain of ownership. Paragraphs (d)(2) and (f) of this section and the small partner exception in paragraph (e)(3) of this section apply only to a partner that is not itself a partnership.

(f) *Foreign related party.* With respect to any person that owns an interest in a partnership, the related party determination in section 59A(g) applies at the partner level.

(g) *Examples.* The following examples illustrate the application of this section.

(1) *Facts.* The following facts are assumed for purposes of the examples.

(i) DC is a domestic corporation that is an applicable taxpayer for purposes section 59A.

(ii) FC is a foreign corporation that is a foreign related party with respect to DC.

(iii) UC is a domestic corporation that is not related to DC and FC.

(iv) Neither FC nor any partnership in the examples is (or is treated as) engaged in a U.S. trade or business or has a permanent establishment in the United States.

(v) All payments apply to a taxable year beginning after December 31, 2017.

(vi) Unless otherwise stated, all allocations are pro-rata and satisfy the requirements of section 704(b) and all the partners have equal interests in the partnership.

(vii) Unless otherwise stated, depreciable property acquired and placed in service by the partnership has a remaining recovery period of five years and is depreciated under the alternative depreciation system of section 168(g) using the straight line method. Solely for purposes of simplifying the calculations in these examples, assume the applicable convention rules in section 168(d) do not apply.

(viii) No exception under § 1.59A-3(b) or (c) applies to any amount paid or accrued.

(2) *Examples—(i) Example 1: Contributions to a partnership on partnership formation—(A) Facts.* DC and FC form partnership PRS, with each contributing depreciable property that has a fair market value and tax basis of \$100x, Property A and Property B, respectively. Therefore, the property contributed by FC, Property B, will generate \$20x of annual section 704(b) and tax depreciation deductions for five years. The depreciation deductions will be allocated \$10x to each of DC and FC each year. Before the transactions, for purposes of section 59A, DC is treated as owning a 100 percent interest in Property A and a zero percent interest in Property B, and FC is treated as owning a 100 percent interest in Property B and a zero percent interest in Property A. After the formation of PRS, for purposes of section 59A, DC and FC are each treated as owning a 50 percent proportionate share of each of Property A and Property B.

(B) *Analysis.* The treatment of contributions of property in exchange for an interest in a partnership is described in paragraph (c)(3)(iii) of this section. Under paragraph (c)(3)(iii) of this section, DC is treated as exchanging a 50 percent interest in Property A for a 50 percent proportionate share of Property B. Under § 1.59A-3(b)(1)(ii), the payment to acquire depreciable property, Property B, from FC is a base erosion payment. The base erosion tax benefit is the amount of depreciation allocated to DC with respect to Property B (\$10x per year) and is not netted with any other partnership item pursuant to paragraph (d)(1) of this section.

(ii) *Example 2: Section 704(c) and remedial allocations—(A) Facts.* The facts are the same as in paragraph (g)(2)(i)(A) of this section (the facts in *Example 1*), except that Property B has a tax basis of \$40x and PRS adopts the remedial method under § 1.704-3(d).

(B) *Analysis.* The analysis and results are the same as in paragraph (g)(2)(i)(B) of this section (the analysis in *Example 1*), except that annual tax depreciation is \$8x (\$40x/5) and annual remedial tax deduction allocation to DC is \$2x (with \$2x of remedial income to FC) for five years. Both the tax depreciation and the remedial tax allocation to DC are base erosion tax benefits to DC under paragraph (d)(1) of this section.

(iii) *Example 3: Sale of a partnership interest without a section 754 election—(A) Facts.* UC and FC are equal partners in partnership PRS, the only asset of which is Property A, a depreciable property with a fair market value of \$200x and a tax basis of \$120x. PRS does not have any section 704(c) assets. DC purchases 50 percent of FC's interest in PRS for \$50x. Prior to the sale, for section 59A purposes, FC is treated as owning a 50 percent proportionate share of Property A and DC is treated as owning no interest in Property A. Following the sale, for

section 59A purposes, DC is treated as owning a 25 percent proportionate share of Property A, all of which is treated as acquired from FC. The partnership does not have an election under section 754 in effect. Property A will generate \$24x of annual tax and section 704(b) depreciation deductions for five years. The depreciation deductions will be allocated \$12x to UC and \$6x to both FC and DC each year.

(B) *Analysis.* The sale of a partnership interest by a partner is analyzed under paragraph (c)(3)(ii) of this section. Under section (c)(3)(ii) of this section, FC is treated as selling to DC 25 percent of Property A. Under § 1.59A-3(b)(1)(ii), the payment to acquire depreciable property is a base erosion payment. Under paragraph (d)(1) of this section, the base erosion tax benefit is the amount of depreciation allocated to DC with respect to the base erosion payment, which would be the depreciation deductions allocated to DC with respect to Property A. DC's annual \$6x depreciation deduction is its base erosion tax benefit with respect to the base erosion payment.

(iv) *Example 4: Sale of a partnership interest with section 754 election—(A) Facts.* The facts are the same as in paragraph (g)(2)(iii)(A) of this section (the facts in *Example 3*), except that the partnership has an election under section 754 in effect. As a result of the sale, there is a \$20x positive adjustment to the tax basis in Property A with respect to DC under section 743(b) (DC's \$50x basis in the PRS interest less DC's \$30x share of PRS's tax basis in Property A). The section 743(b) step-up in tax basis is recovered over a depreciable recovery period of five years. Therefore, DC will be allocated a total of \$10x in annual depreciation deductions for five years, comprised of \$6x with respect to DC's proportionate share of PRS's common tax basis in Property A (\$30x over 5 years) and \$4x with respect to the section 743(b) adjustment (\$20x over 5 years).

(B) *Analysis.* The analysis is the same as in paragraph (g)(2)(iii)(B) of this section (the analysis in *Example 3*); however, because section 743(b) increases the basis in Property A for DC by \$20x, DC is allocated additional depreciation deductions of \$4x per year as a result of the section 743(b) adjustment and has an annual base erosion tax benefit of \$10x (\$6x plus \$4x) for five years under paragraph (d)(1) of this section.

(v) *Example 5: Purchase of depreciable property from a partnership—(A) Facts.* The facts are the same as in paragraph (d)(2)(iii)(A) of this section (the facts in *Example 3*), except that instead of DC purchasing an interest in the partnership, DC purchases Property A from the partnership for \$200x.

(B) *Analysis.* DC must analyze whether the purchase of the depreciable property from the partnership is a base erosion payment under paragraph (c)(2) of this section. Under paragraph (c)(2) of this section, DC is treated as acquiring FC's proportionate share of Property A from FC. Because DC paid the partnership for the partnership's interest in Property A, under paragraph (c)(5)(iii) of this section, DC is treated as paying FC for FC's proportionate share of Property A. Under

§ 1.59A–3(b)(1)(ii), the payment to FC to acquire depreciable property is a base erosion payment. DC's base erosion tax benefit is the amount of depreciation allocated to DC with respect to the base erosion payment, which in this case is the amount of depreciation deductions with respect to the property acquired with a base erosion payment, or the depreciation deductions from FC's (but not UC's) proportionate share of the asset. See § 1.59A–7(d)(1).

(vi) *Example 6: Sale of a partnership interest to a second partnership*—(A) *Facts.* FC, UC1, and UC2 are equal partners in partnership PRS1. DC and UC3 are equal partners in partnership PRS2. UC1, UC2, and UC3 are not related to DC or FC. PRS1's sole asset is Property A, which is depreciable property with a fair market value and tax basis of \$300x. FC sells its entire interest in PRS1 to PRS2 for \$100. For section 59A purposes, FC's proportionate share of Property A prior to the sale is one-third. Following the sale, for section 59A purposes, PRS2's proportionate share of Property A is one-third and DC's proportionate share of Property A (through PRS2) is one-sixth (50 percent of one-third).

(B) *Analysis.* Under paragraph (c)(5)(ii) of this section (the ordering rule), FC's transfer of its interest in PRS1 is first analyzed under paragraph (c)(3) of this section to determine how the transfer of the partnership interest is treated. Then, paragraph (c)(2) of this section applies to analyze how the acquisition of property by PRS2 is treated. Under paragraph (c)(3)(ii) of this section, FC is deemed to transfer its proportionate share of PRS1's assets, which is one-third of Property A. Then, under paragraph (c)(2) of this section, DC is treated as acquiring its proportionate share of PRS2's proportionate share of Property A from FC, which is one-sixth (50 percent of one-third). Under paragraph (c)(5)(iii) of this section, DC is treated as paying for the property it is treated as acquiring from FC. Therefore, DC's deemed payment to FC to acquire depreciable property is a base erosion payment under § 1.59A–3(b)(1)(ii). DC's base erosion tax benefit is equal to DC's distributive share of depreciation deductions that PRS2 allocates to DC attributable to Property A. See § 1.59A–7(d)(1).

(vii) *Example 7: Distribution of cash by a partnership to a foreign related party*—(A) *Facts.* DC, FC, and UC are equal partners in a partnership, PRS, the assets of which consist of cash of \$90x and a depreciable asset (Property A) with a fair market value of \$180x and a tax basis of \$60x. Each partner's interest in PRS has a fair market value of \$90x (\$270x/3) and a tax basis of \$50x. Assume that all non-depreciable assets are capital assets, all depreciable assets are nonresidential real property under section 168, and that no depreciation has been claimed prior to the transaction below. PRS has an election under section 754 in effect. PRS distributes the \$90x of cash to FC in complete liquidation of its interest, resulting in gain to FC of \$40x (\$90x minus its tax basis in PRS of \$50x) under section 731(a)(1) and an increase to the tax basis of Property A under section 734(b) of \$40x. Prior to the distribution, for section 59A purposes, each

partner had a one-third proportionate share of Property A. After the distribution, for section 59A purposes, the remaining partners each have a 50 percent proportionate share of Property A. Each partner's pro-rata allocation of depreciation deductions with respect to Property A is in proportion to each partner's proportionate share of Property A both before and after the distribution. Half of the depreciation deductions attributable to the \$40x section 734(b) step-up will be allocated to DC. In addition, DC's proportionate share of Property A increased from one-third to one-half and therefore DC will be allocated depreciation deductions with respect to half of the original basis of \$60x (or \$30x) instead of one-third of \$60x (or \$20x).

(B) *Analysis.* Distributions of property that cause an increase in the tax basis of property that continues to be held by the partnership are analyzed under paragraph (c)(4) of this section. The \$40x increase in the tax basis of Property A as a result of the distribution of cash to FC is treated as newly purchased property acquired from FC under paragraph (c)(4) of this section and therefore acquired with a base erosion payment under § 1.59A–3(b)(1)(ii) to DC to the extent of DC's proportionate share. DC's base erosion tax benefit is the amount of DC's depreciation deductions attributable to that base erosion payment, which is DC's distributive share of the depreciation deductions with respect to the \$40x increase in the tax basis of Property A. See § 1.59A–7(d)(1). In addition, FC transferred a partnership interest to DC (as defined in paragraph (c)(3)(iv) of this section), which is analyzed under paragraph (c)(3)(i) of this section. Under paragraph (c)(3)(i) of this section, DC is deemed to acquire a one-sixth interest in Property A from FC (the increase in DC's proportionate share from one-third to one-half). DC's base erosion tax benefit from this additional one-sixth interest in Property A is the amount of DC's depreciation deductions attributable to this interest.

(viii) *Example 8: Distribution of property by a partnership to a taxpayer*—(A) *Facts.* The facts are the same as paragraph (g)(2)(vii)(A) of this section (the facts of *Example 7*), except that PRS's depreciable property consists of two assets, Property A having a fair market value of \$90x and a tax basis of \$60x and Property B having a fair market value of \$90x and a tax basis of zero. Instead of distributing cash to FC, PRS distributes Property B to DC in liquidation of its interest, resulting in an increase in the basis of the distributed Property B to DC of \$50x (from zero to \$50x) under section 732(b) because DC's tax basis in the PRS interest was \$50x. For section 59A purposes, prior to the distribution, each partner had a one-third proportionate share of Property B and after the distribution, the property is wholly owned by DC.

(B) *Analysis.* Distributions of property that cause an increase in the tax basis of property that is distributed to a taxpayer are analyzed under paragraph (c)(4) of this section. Under paragraph (c)(4) of this section, the \$50x increase in tax basis is treated as newly purchased property that was acquired with a base erosion payment to the extent that the

increase in tax basis is attributable to FC. Under paragraph (c)(4) of this section, the portion of the increase that is attributable to FC is the proportionate share of the Property B immediately before the distribution that was treated as owned by FC. Immediately before the distribution, FC had a one-third proportionate share of Property B. Accordingly, one-third of the \$50x increase in the tax basis of Property B is treated as if it was newly purchased property acquired by DC from FC with a base erosion payment under § 1.59A–3(b)(1)(ii). DC's base erosion tax benefit is the amount of DC's depreciation deductions with respect to the base erosion payment, which in this case is the depreciation deductions with respect to the one-third interest in the increased basis treated as newly purchased property deemed acquired from FC. See § 1.59A–3(c)(1). In addition, PRS transferred Property B to DC, which is analyzed under paragraph (c)(2) of this section. Prior to the distribution, DC, FC, and UC each owned one-third of Property B. After the distribution, DC entirely owned Property B. Therefore, under paragraph (c)(2) of this section, DC is treated as acquiring one-third of Property B from FC. DC's depreciation deductions with respect to the one-third of Property B acquired from FC (without regard to the basis increase) is also a base erosion tax benefit.

(ix) *Example 9: Distribution of property by a partnership in liquidation of a foreign related party's interest*—(A) *Facts.* The facts are the same as paragraph (g)(2)(viii)(A) (the facts of *Example 8*), except that Property B is not distributed to DC and, instead, Property A is distributed to FC in liquidation of its interest, resulting in a tax basis in Property A of \$50x in FC's hands under section 732(b) and a section 734(b) step-up in Property B of \$10x (because Property A's tax basis was reduced from \$60x to \$50x), allocable to DC and UC. For section 59A purposes, prior to the distribution, each partner had a one-third proportionate share of Property B and after the distribution, DC and UC each have a one-half proportionate share of Property B.

(B) *Analysis.* Distributions of property that cause an increase in the tax basis of property that continues to be held by the partnership are analyzed under paragraph (c)(4) of this section. Under paragraph (c)(4) of this section, because the distribution of Property A to FC from PRS caused an increase in the tax basis of Property B, the entire \$10x increase in tax basis is treated as newly purchased property that was acquired with a base erosion payment under § 1.59A–3(b)(1)(ii). DC's base erosion tax benefit is the amount of DC's depreciation deductions attributable to the base erosion payment, which is DC's distributive share of the depreciation deductions with respect to the \$10x increase in the tax basis of Property B. See § 1.59A–7(d)(1). In addition, under paragraph (c)(3)(i) of this section, DC is deemed to acquire a one-sixth interest in Property B from FC (the increase in DC's proportionate share from one-third to one-half). While this increase is a base erosion payment under § 1.59A–3(b)(1)(ii), there is no base erosion tax benefit from this additional one-sixth interest in Property B because the

tax basis in Property B (without regard to the basis) is zero and therefore the increase in DC's proportionate share does not result in any additional depreciation deductions.

#### **§ 1.59A-8 [Reserved]**

#### **§ 1.59A-9 Anti-abuse and recharacterization rules.**

(a) *Scope.* This section provides rules for recharacterizing certain transactions according to their substance for purposes of applying section 59A and the section 59A regulations. Paragraph (b) of this section provides specific anti-abuse rules. Paragraph (c) of this section provides examples illustrating the rules of paragraph (b) of this section.

(b) *Anti-abuse rules*—(1) *Transactions involving unrelated persons, conduits, or intermediaries.* If a taxpayer pays or accrues an amount to one or more intermediaries (including an intermediary unrelated to the taxpayer) that would have been a base erosion payment if paid or accrued to a foreign related party, and one or more of the intermediaries makes (directly or indirectly) corresponding payments to or for the benefit of a foreign related party as part of a transaction (or series of transactions), plan or arrangement that has as a principal purpose avoiding a base erosion payment (or reducing the amount of a base erosion payment), the role of the intermediary or intermediaries is disregarded as a conduit, or the amount paid or accrued to the intermediary is treated as a base erosion payment, as appropriate.

(2) *Transactions to increase the amount of deductions taken into account in the denominator of the base erosion percentage computation.* A transaction (or component of a transaction or series of transactions), plan or arrangement that has a principal purpose of increasing the deductions taken into account for purposes of § 1.59A-2(e)(3)(i)(B) (the denominator of the base erosion percentage computation) is disregarded for purposes of § 1.59A-2(e)(3).

(3) *Transactions to avoid the application of rules applicable to banks and registered securities dealers.* A transaction (or series of transactions), plan or arrangement that occurs among related parties that has a principal purpose of avoiding the rules applicable to certain banks and registered securities dealers in § 1.59A-2(e)(2) (base erosion percentage test for banks and registered securities dealers) or § 1.59A-5(c)(2) (increased base erosion and anti-abuse tax rate for banks and registered securities dealers) is not taken into account for purposes of § 1.59A-2(e)(2) or § 1.59A-5(c)(2).

(4) *Nonrecognition transactions.* 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 § 1.59A-3(b)(3)(viii)(A) will not apply to the specified nonrecognition transaction. For purposes of this paragraph (b)(4), if a transaction (or series of transactions), plan or arrangement between related parties increases the adjusted basis of property within the six month period before the taxpayer acquires the property in a specified nonrecognition transaction, the transaction (or series of transactions), plan or arrangement is deemed to have a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in a nonrecognition transaction.

(c) *Examples.* The following examples illustrate the application of this section.

(1) *Facts.* The following facts are assumed for purposes of the examples.

(i) DC is a domestic corporation that is an applicable taxpayer for purposes section 59A.

(ii) FP is a foreign corporation that owns all the stock of DC.

(iii) None of the foreign corporations have income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or regulations thereunder.

(iv) All payments occur in a taxable year beginning after December 31, 2017.

(2) *Example 1: Substitution of payments that are not base erosion payments for payments that otherwise would be base erosion payments through a conduit or intermediary*—(i) *Facts.* FP owns Property 1 with a fair market value of \$95x, which FP intends to transfer to DC. A payment from DC to FP for Property 1 would be a base erosion payment. Corp A is a domestic corporation that is not a related party with respect to DC. As part of a plan with a principal purpose of avoiding a base erosion payment, FP enters into an arrangement with Corp A to transfer Property 1 to Corp A in exchange for \$95x. Pursuant to the same plan, Corp A transfers Property 1 to DC in exchange for \$100x. Property 1 is subject to the allowance for depreciation (or amortization in lieu of depreciation) in the hands of DC.

(ii) *Analysis.* The arrangement between FP, DC, and Corp A is deemed to result in a \$95x base erosion payment under paragraph (b)(1) of this section because DC's payment to Corp A would have been a base erosion payment if paid to a foreign related party, and Corp A makes a corresponding payment to FP as part of the series of transactions that has as a principal purpose avoiding a base erosion payment.

(3) *Example 2: Alternative transaction to base erosion payment*—(i) *Facts.* The facts

are the same as in paragraph (c)(2)(i) of this section (the facts in *Example 1*), except that DC does not purchase Property 1 from FP or Corp A. Instead, DC purchases Property 2 from Corp B, a domestic corporation that is not a related party with respect to DC and that originally produced or acquired Property 2 for Corp B's own account. Property 2 is substantially similar to Property 1, and DC uses Property 2 in substantially the same manner that DC would have used Property 1.

(ii) *Analysis.* Paragraph (b)(1) of this section does not apply to the transaction between DC and Corp B because Corp B does not make a corresponding payment to or for the benefit of FP as part of a transaction, plan or arrangement.

(4) *Example 3: Alternative financing source*—(i) *Facts.* On Date 1, FP loaned \$200x to DC in exchange for Note A. DC pays or accrues interest annually on Note A, and the payment or accrual is a base erosion payment within the meaning of § 1.59A-3(b)(1)(i). On Date 2, DC borrows \$200x from Bank, a corporation that is not a related party with respect to DC, in exchange for Note B. The terms of Note B are substantially similar to the terms of Note A. DC uses the proceeds from Note B to repay Note A.

(ii) *Analysis.* Paragraph (b)(1) of this section does not apply to the transaction between DC and Bank because Bank does not make a corresponding payment to or for the benefit of FP as part of the series of transactions.

(5) *Example 4: Alternative financing source that is a conduit*—(i) *Facts.* The facts are the same as in paragraph (c)(4)(i) of this section (the facts in *Example 3*) except that in addition, as part of the same plan or arrangement as the Note B transaction and with a principal purpose of avoiding a base erosion payment, FP deposits \$250x with Bank. The difference between the interest rate paid by Bank to FP on FP's deposit and the interest rate paid by DC to Bank is less than one percentage point. The interest rate charged by Bank to DC would have differed absent the deposit by FP.

(ii) *Analysis.* The transactions between FP, DC, and Bank are deemed to result in a base erosion payment under paragraph (b)(1) of this section because DC's payment to Bank would have been a base erosion payment if paid to a foreign related party, and Bank makes a corresponding payment to FP as part of the series of transactions that has as a principal purpose avoiding a base erosion payment. See Rev. Rul. 87-89, 1987-2 C.B. 195, Situation 3.

(6) *Example 5: Intermediary acquisition*—(i) *Facts.* FP owns all of the stock of DC1 and DC2, each domestic corporations. FP is a manufacturer of lawn equipment. DC1 is in the trade or business of renting equipment to unrelated third parties. DC2 is a dealer in property that capitalizes its purchases into inventory and recovers the amount through cost of goods sold. Before Date 1, in the ordinary course of DC1's business, DC1 acquired depreciable property from FP that DC1 in turn rented to unrelated third parties. DC1's purchases from FP were base erosion payments within the meaning of § 1.59A-3(b)(1)(ii). On Date 1, with a principal purpose of avoiding a base erosion payment,



FP and DC2 reorganized their operations so that DC2 acquires the lawn equipment from FP and immediately thereafter, DC2 resells the lawn equipment to DC1.

(ii) *Analysis.* The transactions between FP, DC1, and DC2 are deemed to result in a base erosion payment under paragraph (b)(1) of this section because DC1's payment to DC2 would have been a base erosion payment if paid directly to FP, and DC2 makes a corresponding payment to FP as part of a series of transactions, plan, or arrangement that has a principal purpose of avoiding a base erosion payment from DC1 to FP.

(7) *Example 6: Offsetting transactions to increase the amount of deductions taken into account in the denominator of the base erosion percentage computation—(i) Facts.* With a principal purpose of increasing the deductions taken into account by DC for purposes of § 1.59A-2(e)(3)(i)(B), DC enters into a long position with respect to Asset with Financial Institution 1 and simultaneously enters into a short position with respect to Asset with Financial Institution 2. Financial Institution 1 and Financial Institution 2 are not related to DC and are not related to each other.

(ii) *Analysis.* Paragraph (b)(2) of this section applies to the transactions between DC and Financial Institution 1 and DC and Financial Institution 2. These transactions are not taken into account for purposes of § 1.59A-2(e)(3)(i)(B) because the transactions have a principal purpose of increasing the deductions taken into account for purposes of § 1.59A-2(e)(3)(i)(B).

(8) *Example 7: Ordinary course transactions that increase the amount of deductions taken into account in the denominator of the base erosion percentage computation—(i) Facts.* DC, a financial institution, enters into a long position with respect to stock in Corporation with Person 1 and later on the same day enters into a short position with respect to stock in Corporation with Person 2. Person 1 and Person 2 are not related to DC and are not related to each other. DC entered into the positions in the ordinary course of its business and did not have a principal purpose of increasing the deductions taken into account by DC for purposes of § 1.59A-2(e)(3)(i)(B).

(ii) *Analysis.* Paragraph (b)(2) of this section does not apply because the transactions between DC and Person 1 and Person 2 were not entered into with a principal purpose of increasing the deductions taken into account by DC for purposes of § 1.59A-2(e)(3)(i)(B).

(9) *Example 8: Transactions to avoid the application of rules applicable to banks and registered securities dealers—(i) Facts.* DC owns all of the stock of DC1 and Bank (an entity defined in section 581). DC, DC1, and Bank are members of an affiliated group of corporations within the meaning of section 1504(a) that elect to file a consolidated U.S. federal income tax return. With a principal purpose of avoiding the rules of § 1.59A-2(e)(2) or § 1.59A-5(c)(2), DC and DC1 form a new partnership (PRS). DC contributes all of its stock of Bank, and DC1 contributes cash, to PRS. DC, DC1, and Bank do not materially change their business operations following the formation of PRS.

(ii) *Analysis.* Paragraph (b)(3) of this section applies to transactions with respect to Bank because the transactions with respect to PRS were entered into with a principal purpose of avoiding the rules of § 1.59A-2(e)(2) or § 1.59A-5(c)(2). The contribution of Bank to a PRS is not taken into account, and Bank will be deemed to be part of the affiliated group including DC and DC1 for purposes of § 1.59A-2(e)(2) and § 1.59A-5(c)(2).

(10) *Example 9: Transactions that do not avoid the application of rules applicable to banks and registered securities dealers—(i) Facts.* The facts are the same as the facts of paragraph (c)(9)(i) of this section (the facts of Example 8), except that DC sells 90 percent of the stock of Bank to an unrelated party in exchange for cash.

(ii) *Analysis.* Paragraph (b)(3) of this section does not apply to DC's sale of the stock of Bank because the sale was not made with a principal purpose of avoiding the rules of § 1.59A-2(e)(2) or § 1.59A-5(c)(2). Bank will not be treated as part of the affiliated group including DC and DC1 for purposes of § 1.59A-2(e)(2) and § 1.59A-5(c)(2).

(11) *Example 10: Acquisition of depreciable property in a nonrecognition transaction—(i) Facts.* U, which is not a related party with respect to FP or DC, owns Property 1 with an adjusted basis of \$50x and a fair market value of \$100x. On Date 1, FP purchases property, including Property 1, from U in exchange for cash, and then FP contributes Property 1 to DC in an exchange described in section 351. Following the exchange, DC's basis in Property 1 is \$100x.

(ii) *Analysis.* Paragraph (b)(4) of this section does not apply to DC's acquisition of Property 1 because the purchase of Property 1 from U (along with the purchase of other property from U that FP did not contribute to DC) did not have a principal purpose of increasing the adjusted basis of property that was subsequently transferred to DC. The transaction is economically equivalent to an alternative transaction under which FP contributed \$100x to DC and then DC purchased Property 1 from U. Further, the second sentence of paragraph (b)(4) of this section (providing that certain transactions are deemed to have a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in a nonrecognition transaction) does not apply because FP purchased Property 1 from an unrelated party.

(12) *Example 11: Transactions between related parties with a principal purpose of increasing the adjusted basis of property—(i) Facts.* The facts are the same as paragraph (c)(11)(i) of this section (the facts in Example 10), except that U is related to FP and DC.

(ii) *Analysis.* Paragraph (b)(4) of this section applies to DC's acquisition of Property 1 because the transaction that increased the adjusted basis of Property 1 (the purchase of Property 1 from U) was between related parties, and within six months DC acquired Property 1 from FP in a specified nonrecognition transaction. Accordingly, the purchase of property from U is deemed to have a principal purpose of increasing the adjusted basis of Property 1,

the exception in § 1.59A-3(b)(3)(viii)(A) for specified nonrecognition transactions will not apply to the contribution of Property 1 to DC, and DC's depreciation deductions with respect to Property 1 will be base erosion tax benefits.

#### § 1.59A-10 Applicability date.

Sections 1.59A-1 through 1.59A-9 apply to taxable years ending on or after December 17, 2018. However, taxpayers may apply these final regulations in their entirety for taxable years beginning after December 31, 2017, and ending before December 17, 2018. In lieu of applying these final regulations, taxpayers may apply the provisions matching §§ 1.59A-1 through 1.59A-9 from the Internal Revenue Bulletin (IRB) 2019-02 (<https://www.irs.gov/pub/irs-irbs/irb19-02.pdf>) in their entirety for all taxable years ending on or before December 6, 2019.

■ **Par. 3.** Section 1.383-1 is amended by adding two sentences at the end of paragraph (d)(3)(i) to read as follows:

#### § 1.383-1 Special limitations on certain capital losses and excess credits.

\* \* \* \* \*

(d) \* \* \*

(3) \* \* \*

(i) \* \* \* The application of section 59A is not a limitation contained in subtitle A for purposes of this paragraph (d)(3)(i). Therefore, the treatment of pre-change losses and pre-change credits in the computation of the base erosion minimum tax amount will not affect whether such losses or credits result in absorption of the section 382 limitation and the section 383 credit limitation.

\* \* \* \* \*

■ **Par. 4.** Section 1.1502-2 is revised to read as follows:

#### § 1.1502-2 Computation of tax liability.

(a) *Taxes imposed.* The tax liability of a group for a consolidated return year is determined by adding together—

(1) The tax imposed by section 11(a) in the amount described in section 11(b) on the consolidated taxable income for the year (reduced by the taxable income of a member described in paragraphs (a)(5) through (8) of this section);

(2) The tax imposed by section 541 on the consolidated undistributed personal holding company income;

(3) If paragraph (a)(2) of this section does not apply, the aggregate of the taxes imposed by section 541 on the separate undistributed personal holding company income of the members which are personal holding companies;

(4) If neither paragraph (a)(2) nor (3) of this section apply, the tax imposed by section 531 on the consolidated accumulated taxable income (see § 1.1502-43);



(5) The tax imposed by section 594(a) in lieu of the taxes imposed by section 11 on the taxable income of a life insurance department of the common parent of a group which is a mutual savings bank;

(6) The tax imposed by section 801 on consolidated life insurance company taxable income;

(7) The tax imposed by section 831(a) on consolidated insurance company taxable income of the members which are subject to such tax;

(8) Any increase in tax described in section 1351(d)(1) (relating to recoveries of foreign expropriation losses); and

(9) The tax imposed by section 59A on base erosion payments of taxpayers with substantial gross receipts.

(b) *Credits.* A group is allowed as a credit against the taxes described in paragraph (a) of this section (except for paragraph (a)(9) of this section) of this section: The general business credit under section 38 (see § 1.1502-3), the foreign tax credit under section 27 (see § 1.1502-4), and any other applicable credits provided under the Internal Revenue Code. Any increase in tax due to the recapture of a tax credit will be taken into account. See section 59A and the regulations thereunder for credits allowed against the tax described in paragraph (a)(9) of this section.

(c) *Allocation of dollar amounts.* For purposes of this section, if a member or members of the consolidated group are also members of a controlled group that includes corporations that are not members of the consolidated group, any dollar amount described in any section of the Internal Revenue Code is apportioned among all members of the controlled group in accordance with the provisions of the applicable section and the regulations thereunder.

(d) *Applicability date.*—This section applies to taxable years for which the original consolidated Federal income tax return is due (without extension) after December 6, 2019.

■ **Par. 5** Section 1.1502-4 is amended by revising paragraph (d)(3) to read as follows:

**§ 1.1502-4 Consolidated foreign tax credit.**

\* \* \* \* \*

(d) \* \* \*

(3) *Computation of tax against which credit is taken.* The tax against which the limiting fraction under section 904(a) is applied will be the consolidated tax liability of the group determined under § 1.1502-2, but without regard to paragraphs (a)(2), (3), (4), (8), and (9) of that section, and without regard to any credit against such liability.

\* \* \* \* \*

■ **Par. 6.** Section 1.1502-43 is amended by revising paragraph (b)(2)(i)(A) to read as follows:

**§ 1.1502-43 Consolidated accumulated earnings tax.**

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(i) \* \* \*

(A) The consolidated liability for tax determined without § 1.1502-2(a)(2) through (4), and without the foreign tax credit provided by section 27, over

\* \* \* \* \*

■ **Par. 7.** Section 1.1502-47 is amended by revising paragraph (f)(7)(iii) to read as follows.

**§ 1.1502-47 Consolidated returns by life-nonlife groups.**

\* \* \* \* \*

(f) \* \* \*

(7) \* \* \*

(iii) Any taxes described in § 1.1502-2 (other than by paragraphs (a)(1) and (6) of that section).

\* \* \* \* \*

■ **Par. 8.** Section 1.1502-59A is added to read as follows:

**§ 1.1502-59A Application of section 59A to consolidated groups.**

(a) *Scope.* This section provides rules for the application of section 59A and the regulations thereunder (the *section 59A regulations*) to consolidated groups and their members (as defined in § 1.1502-1(h) and (b), respectively). Rules in the section 59A regulations apply to consolidated groups except as modified in this section. Paragraph (b) of this section provides rules treating a consolidated group (rather than each member of the group) as a single taxpayer, and a single applicable taxpayer, as relevant, for certain purposes. Paragraph (c) of this section coordinates the application of the business interest stacking rule under § 1.59A-3(c)(4) to consolidated groups. Paragraph (d) of this section addresses how the base erosion minimum tax amount is allocated among members of the consolidated group. Paragraph (e) of this section coordinates the application of this section and § 1.1502-47.

Paragraph (f) of this section sets forth definitions. Paragraph (g) of this section provides examples. Paragraph (h) of this section provides the applicability date.

(b) *Consolidated group as the applicable taxpayer.*—(1) *In general.* For purposes of determining whether the consolidated group is an applicable taxpayer (within the meaning of § 1.59A-2(b)) and the amount of tax due pursuant to section 59A(a), all members of a consolidated group are treated as a

single taxpayer. Thus, for example, members' deductions are aggregated in making the required computations under section 59A. In addition, to ensure that intercompany transactions (as defined in § 1.1502-13(b)(1)(i)) do not affect the consolidated group's base erosion percentage or base erosion minimum tax amount, items resulting from intercompany transactions are not taken into account in making such computations under section 59A. For example, additional depreciation deductions resulting from intercompany asset sales are not taken into account for purposes of applying the base erosion percentage test under § 1.59A-2(e).

(2) *Consolidated group as member of the aggregate group.* The consolidated group is treated as a single member of an aggregate group for purposes of § 1.59A-2(c).

(3) *Related party determination.* For purposes of section 59A and the section 59A regulations, if a person is a related party with respect to any member of a consolidated group, that person is a related party of the group and of each of its members.

(c) *Coordination of section 59A(c)(3) and section 163(j) in a consolidated group.*—(1) *Overview.* This paragraph (c) provides rules regarding the application of § 1.59A-3(c)(4) to a consolidated group's section 163(j) interest deduction. The classification rule in paragraph (c)(3) of this section addresses how to determine if, and to what extent, the group's section 163(j) interest deduction is a base erosion tax benefit. These regulations contain a single-entity classification rule with regard to the deduction of the consolidated group's aggregate current year business interest expense ("BIE"), but a separate-entity classification rule for the deduction of the consolidated group's disallowed BIE carryforwards. Paragraph (c)(3) of this section classifies the group's aggregate current year BIE deduction, in conformity with § 1.59A-3(c)(4), as constituting domestic related current year BIE deduction, foreign related current year BIE deduction, or unrelated current year BIE deduction. The allocation rules in paragraph (c)(4) of this section then allocate to specific members of the group the domestic related current year BIE deduction, foreign related current year BIE deduction, and unrelated current year BIE deduction taken in the taxable year. Any member's current year BIE that is carried forward to the succeeding taxable year as a disallowed BIE carryforward is allocated a status as domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward under

paragraph (c)(5) of this section. The status of any disallowed BIE carryforward deducted by a member in a later year is classified on a separate-entity basis by the deducting member under paragraph (c)(3) of this section, based on the status allocated to the member's disallowed BIE carryforward under paragraph (c)(5) of this section. This paragraph (c) also provides rules regarding the consequences of the deconsolidation of a corporation that has been allocated a domestic related BIE carryforward status, a foreign related BIE carryforward status, or an unrelated BIE carryforward status; and the consolidation of a corporation with a disallowed BIE carryforward classified as from payments to a domestic related party, foreign related party, or unrelated party.

(2) *Absorption rule for the group's business interest expense.* To determine the amount of the group's section 163(j) interest deduction, and to determine the year in which the member's business interest expense giving rise to the deduction was incurred or accrued, see §§ 1.163(j)-4(d) and 1.163(j)-5(b)(3).

(3) *Classification of the group's section 163(j) interest deduction—(i) In general.* Consistent with § 1.59A-3(c)(4)(i) and paragraph (b) of this section, the classification rule of this paragraph (c)(3) determines whether the consolidated group's section 163(j) interest deduction is a base erosion tax benefit. To the extent the consolidated group's business interest expense is permitted as a deduction under section 163(j)(1) in a taxable year, the deduction is classified first as from business interest expense paid or accrued to a foreign related party and business interest expense paid or accrued to a domestic related party (on a pro-rata basis); any remaining deduction is treated as from business interest expense paid or accrued to an unrelated party.

(ii) *Year-by-year application of the classification rule.* If the consolidated group's section 163(j) interest deduction in any taxable year is attributable to business interest expense paid or accrued in more than one taxable year (for example, the group deducts the group's aggregate current year BIE, the group's disallowed BIE carryforward from year 1, and the group's disallowed BIE carryforward from year 2), the classification rule in paragraph (c)(3)(i) of this section applies separately to each of those years, pursuant to paragraphs (c)(3)(iii) and (iv) of this section.

(iii) *Classification of current year BIE deductions.* Current year BIE deductions are classified under the section 59A regulations and this paragraph (c) as if

the consolidated group were a single taxpayer that had paid or accrued the group's aggregate current year BIE to domestic related parties, foreign related parties, and unrelated parties. The rules of paragraph (c)(4) of this section apply for allocating current year BIE deductions among members of the consolidated group. To the extent the consolidated group's aggregate current year BIE exceeds its section 163(j) limitation, the rules of paragraph (c)(5) of this section apply.

(iv) *Classification of deductions of disallowed BIE carryforwards.* Each member of the group applies the classification rule in this paragraph (c)(3) to its deduction of any part of a disallowed BIE carryforward from a year, after the group applies paragraph (c)(5) of this section to the consolidated group's disallowed BIE carryforward from that year. Therefore, disallowed BIE carryforward that is actually deducted by a member is classified based on the status of the components of that carryforward, assigned pursuant to paragraph (c)(5) of this section.

(4) *Allocation of domestic related current year BIE deduction status and foreign related current year BIE deduction status among members of the consolidated group—(i) In general.* This paragraph (c)(4) applies if the group has domestic related current year BIE deductions, foreign related current year BIE deductions, or both, as a result of the application of the classification rule in paragraph (c)(3) of this section. Under this paragraph (c)(4), the domestic related current year BIE, foreign related current year BIE, or both, that is treated as deducted in the current year are deemed to have been incurred pro-rata by all members that have current year BIE deduction in that year, regardless of which member or members actually incurred the current year BIE to a domestic related party or a foreign related party.

(ii) *Domestic related current year BIE deduction—(A) Amount of domestic related current year BIE deduction status allocable to a member.* The amount of domestic related current year BIE deduction status that is allocated to a member is determined by multiplying the group's domestic related current year BIE deduction (determined pursuant to paragraph (c)(3) of this section) by the percentage of current year BIE deduction allocable to such member in that year.

(B) *Percentage of current year BIE deduction allocable to a member.* The percentage of current year BIE deduction allocable to a member is equal to the amount of the member's current year BIE deduction divided by

the amount of the group's aggregate current year BIE deduction.

(iii) *Amount of foreign related current year BIE deduction status allocable to a member.* The amount of foreign related current year BIE deduction status that is allocated to a member is determined by multiplying the group's foreign related current year BIE deduction (determined pursuant to paragraph (c)(3) of this section) by the percentage of current year BIE deduction allocable to such member (defined in paragraph (c)(4)(ii)(B) of this section).

(iv) *Treatment of amounts as having unrelated current year BIE deduction status.* To the extent the amount of a member's current year BIE that is absorbed under paragraph (c)(2) of this section exceeds the domestic related current year BIE deduction status and foreign related current year BIE deduction status allocated to the member under paragraph (c)(4)(ii) and (iii) of this section, such excess amount is treated as from payments or accruals to an unrelated party.

(5) *Allocation of domestic related BIE carryforward status and foreign related BIE carryforward status to members of the group—(i) In general.* This paragraph (c)(5) applies in any year the consolidated group's aggregate current year BIE exceeds its section 163(j) limitation. After the application of paragraph (c)(4) of this section, any remaining domestic related current year BIE, foreign related current year BIE, and unrelated current year BIE is deemed to have been incurred pro-rata by members of the group pursuant to the rules in paragraph (c)(5)(ii), (iii), and (iv) of this section, regardless of which member or members actually incurred the business interest expense to a domestic related party, foreign related party, or unrelated party.

(ii) *Domestic related BIE carryforward—(A) Amount of domestic related BIE carryforward status allocable to a member.* The amount of domestic related BIE carryforward status that is allocated to a member equals the group's domestic related BIE carryforward from that year multiplied by the percentage of disallowed BIE carryforward allocable to the member.

(B) *Percentage of disallowed BIE carryforward allocable to a member.* The percentage of disallowed BIE carryforward allocable to a member for a taxable year equals the member's disallowed BIE carryforward from that year divided by the consolidated group's disallowed BIE carryforwards from that year.

(iii) *Amount of foreign related BIE carryforward status allocable to a member.* The amount of foreign related

BIE carryforward status that is allocated to a member equals the group's foreign related BIE carryforward from that year multiplied by the percentage of disallowed BIE carryforward allocable to the member (as defined in paragraph (c)(5)(ii)(B) of this section).

(iv) *Treatment of amounts as having unrelated BIE carryforward status.* If a member's disallowed BIE carryforward for a year exceeds the amount of domestic related BIE carryforward status and foreign related BIE carryforward status that is allocated to the member pursuant to paragraphs (c)(5)(ii) and (iii) of this section, respectively, the excess carryforward amount is treated as from payments or accruals to an unrelated party.

(v) *Coordination with section 381.* If a disallowed BIE carryforward is allocated a status as a domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward under the allocation rule of paragraph (c)(5) of this section, the acquiring corporation in a transaction described in section 381(a) will succeed to and take into account the allocated status of the carryforward for purposes of section 59A. See § 1.381(c)(20)–1.

(6) *Member deconsolidates from a consolidated group*—(i) *General rule.* When a member deconsolidates from a group (the original group), the member's disallowed BIE carryforwards retain their allocated status, pursuant to paragraph (c)(5) of this section, as a domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward (as applicable). Following the member's deconsolidation, the status of the disallowed BIE carryforwards of the remaining members is not redetermined.

(ii) *Gross receipts exception.* This paragraph (c)(6)(ii) applies if the original group had insufficient gross receipts to satisfy the gross receipts test under § 1.59A–2(d) and thus was not an applicable taxpayer in the year in which the deconsolidating member's disallowed BIE carryforward was incurred. If this paragraph (c)(6)(ii) applies, the deconsolidating member may determine the status of its disallowed BIE carryforward from that year by applying the classification rule of § 1.59A–3(c)(4) solely to the interest payments or accruals of the deconsolidating member, rather than by applying § 1.1502–59A(c)(3).

(iii) *Failure to substantiate.* If the deconsolidating member fails to substantiate a disallowed BIE carryforward as a domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward, then the disallowed BIE

carryforward is treated as a foreign related BIE carryforward.

(7) *Corporation joins a consolidated group.* If a corporation joins a consolidated group (the acquiring group), and that corporation was allocated a domestic related BIE carryforward status, foreign related BIE carryforward status, or unrelated BIE carryforward status pursuant to paragraph (c)(5) of this section from another consolidated group (the original group), or separately has a disallowed BIE carryforward that is classified as from payments or accruals to a domestic related party, foreign related party, or unrelated party, the status of the carryforward is taken into account in determining the acquiring group's base erosion tax benefit when the corporation's disallowed BIE carryforward is absorbed.

(d) *Allocation of the base erosion minimum tax amount to members of the consolidated group.* For rules regarding the allocation of the base erosion minimum tax amount, see section 1552. Allocations under section 1552 take into account the classification and allocation provisions of paragraphs (c)(3) through (5) of this section.

(e) [Reserved]

(f) *Definitions.* The following definitions apply for purposes of this section—

(1) *Aggregate current year BIE.* The consolidated group's *aggregate current year BIE* is the aggregate of all members' current year BIE.

(2) *Aggregate current year BIE deduction.* The consolidated group's *aggregate current year BIE deduction* is the aggregate of all members' current year BIE deductions.

(3) *Applicable taxpayer.* The term *applicable taxpayer* has the meaning provided in § 1.59A–2(b).

(4) *Base erosion minimum tax amount.* The consolidated group's *base erosion minimum tax amount* is the tax imposed under section 59A.

(5) *Base erosion tax benefit.* The term *base erosion tax benefit* has the meaning provided in § 1.59A–3(c)(1).

(6) *Business interest expense.* The term *business interest expense*, with respect to a member and a taxable year, has the meaning provided in § 1.163(j)–1(b)(2), and with respect to a consolidated group and a taxable year, has the meaning provided in § 1.163(j)–4(d)(2)(iii).

(7) *Consolidated group's disallowed BIE carryforwards.* The term *consolidated group's disallowed BIE carryforwards* has the meaning provided in § 1.163(j)–5(b)(3)(i).

(8) *Current year BIE.* A member's *current year BIE* is the member's

business interest expense that would be deductible in the current taxable year without regard to section 163(j) and that is not a disallowed business interest expense carryforward from a prior taxable year.

(9) *Current year BIE deduction.* A member's *current year BIE deduction* is the member's current year BIE that is permitted as a deduction in the taxable year.

(10) *Domestic related BIE carryforward.* The consolidated group's *domestic related BIE carryforward* for any taxable year is the excess of the group's domestic related current year BIE over the group's domestic related current year BIE deduction (if any).

(11) *Domestic related current year BIE.* The consolidated group's *domestic related current year BIE* for any taxable year is the consolidated group's aggregate current year BIE paid or accrued to a domestic related party.

(12) *Domestic related current year BIE deduction.* The consolidated group's *domestic related current year BIE deduction* for any taxable year is the portion of the group's aggregate current year BIE deduction classified as from interest paid or accrued to a domestic related party under paragraph (c)(3) of this section.

(13) *Domestic related party.* A *domestic related party* is a related party that is not a foreign related party and is not a member of the same consolidated group.

(14) *Disallowed BIE carryforward.* The term *disallowed BIE carryforward* has the meaning provided in § 1.163(j)–1(b)(9).

(15) *Foreign related BIE carryforward.* The consolidated group's *foreign related BIE carryforward* for any taxable year, is the excess of the group's foreign related current year BIE over the group's foreign related current year BIE deduction (if any).

(16) *Foreign related current year BIE.* The consolidated group's *foreign related current year BIE* for any taxable year is the consolidated group's aggregate current year BIE paid or accrued to a foreign related party.

(17) *Foreign related current year BIE deduction.* The consolidated group's *foreign related current year BIE deduction* for any taxable year is the portion of the consolidated group's aggregate current year BIE deduction classified as from interest paid or accrued to a foreign related party under paragraph (c)(3) of this section.

(18) *Foreign related party.* A *foreign related party* has the meaning provided in § 1.59A–1(b)(12).

(19) *Related party.* The term *related party* has the meaning provided in

§ 1.59A–1(b)(17), but excludes members of the same consolidated group.

(20) *Section 163(j) interest deduction.* The term *section 163(j) interest deduction* means, with respect to a taxable year, the amount of the consolidated group's business interest expense permitted as a deduction pursuant to § 1.163(j)–5(b)(3) in the taxable year.

(21) *Section 163(j) limitation.* The term *section 163(j) limitation* has the meaning provided in § 1.163(j)–1(b)(31).

(22) *Unrelated BIE carryforward.* The consolidated group's *unrelated BIE carryforward* for any taxable year is the excess of the group's unrelated current year BIE over the group's unrelated current year BIE deduction.

(23) *Unrelated current year BIE.* The consolidated group's *unrelated current year BIE* for any taxable year is the consolidated group's aggregate current year BIE paid or accrued to an unrelated party.

(24) *Unrelated current year BIE deduction.* The consolidated group's *unrelated current year BIE deduction* for any taxable year is the portion of the group's aggregate current year BIE deduction classified as from interest paid or accrued to an unrelated party under paragraph (c)(3) of this section.

(25) *Unrelated party.* An *unrelated party* is a party that is not a related party.

(g) *Examples.* The following examples illustrate the general application of this section. For purposes of the examples, a foreign corporation (FP) wholly owns domestic corporation (P), which in turn wholly owns S1 and S2. P, S1, and S2 are members of a consolidated group. The consolidated group is a calendar year taxpayer.

(1) *Example 1: Computation of the consolidated group's base erosion minimum tax amount.* (i) *The consolidated group is the applicable taxpayer—(A) Facts.* The members have never engaged in intercompany transactions. For the 2019 taxable year, P, S1, and S2 were permitted the following amounts of deductions (within the meaning of section 59A(c)(4)), \$2,400x, \$1,000x, and \$2,600x; those deductions include base erosion tax benefits of \$180x, \$370x, and \$230x. The group's consolidated taxable income for the year is \$150x. In addition, the group satisfies the gross receipts test in § 1.59A–2(d).

(B) *Analysis.* Pursuant to paragraph (b) of this section, the receipts and deductions of P, S1, and S2 are aggregated for purposes of making the computations under section 59A. The group's base erosion percentage is 13% ( $(\$180x + \$370x + \$230x) / (\$2,400x + \$1,000x + \$2,600x)$ ). The consolidated group is an applicable taxpayer under § 1.59A–2(b) because the group satisfies the gross receipts test and the group's base erosion percentage (13%) is higher than 3%. The consolidated

group's modified taxable income is computed by adding back the members' base erosion tax benefits (and, when the consolidated group has consolidated net operating loss available for deduction, the consolidated net operating loss allowed multiplied by the base erosion percentage) to the consolidated taxable income,  $\$930x (\$150x + \$180x + \$370x + \$230x)$ . The group's base erosion minimum tax amount is then computed as 10 percent of the modified taxable income less the regular tax liability,  $\$61.5x (\$930x \times 10\% - \$150x \times 21\%)$ .

(ii) *The consolidated group engages in intercompany transactions—(A) Facts.* The facts are the same as in paragraph (g)(1)(i)(A) of this section (the facts in *Example 1*(i)), except that S1 sold various inventory items to S2 during 2019. Such items are depreciable in the hands of S2 (but would not have been depreciable in the hands of S1) and continued to be owned by S2 during 2019.

(B) *Analysis.* The result is the same as paragraph (g)(1)(i)(A) of this section (the facts in *Example 1*(i)). Pursuant to paragraph (b)(2) of this section, items resulting from the intercompany sale (for example, gross receipts, depreciation deductions) are not taken into account in computing the group's gross receipts under § 1.59A–2(d) and base erosion percentage under § 1.59A–2(e)(3).

(2) *Example 2: Business interest expense subject to section 163(j) and the group's domestic related current year BIE and foreign related current year BIE for the year equals its section 163(j) limitation—(i) Facts.* During the current year (Year 1), P incurred \$150x of business interest expense to domestic related parties; S1 incurred \$150x of business interest expense to foreign related parties; and S2 incurred \$150x of business interest expense to unrelated parties. The group's section 163(j) limitation for the year is \$300x. After applying the rules in § 1.163(j)–5(b)(3), the group deducts \$150x of P's Year 1 business interest expense, and \$75x each of S1 and S2's Year 1 business interest expense. Assume the group is an applicable taxpayer for purposes of section 59A.

(ii) *Analysis—(A) Application of the absorption rule in paragraph (c)(2) of this section.* Following the rules in section 163(j), the group's section 163(j) interest deduction for Year 1 is \$300x, and the entire amount is from members' Year 1 business interest expense.

(B) *Application of the classification rule in paragraph (c)(3) of this section.* Under paragraph (c)(3) of this section, the group's aggregate current year BIE deduction of \$300x is first classified as payments or accruals to related parties (pro-rata among domestic related parties and foreign related parties), and second as payments or accruals to unrelated parties. For Year 1, the group has \$150x of domestic related current year BIE and \$150x of foreign related current year BIE, and the group's aggregate current year BIE deduction will be classified equally among the related party expenses. Therefore, \$150x of the group's deduction is classified as domestic related current year BIE deduction and \$150x is classified as a foreign related current year BIE deduction.

(C) *Application of the allocation rule in paragraph (c)(4) of this section.* After the

application of the classification rule in paragraph (c)(3) of this section, the group has \$150x each of domestic related current year BIE deduction and foreign related current year BIE deduction from the group's aggregate current year BIE in Year 1. The domestic related current year BIE deduction and foreign related current year BIE deduction will be allocated to P, S1, and S2 based on each member's deduction of its Year 1 business interest expense.

(1) *Allocations to P.* The percentage of current year BIE deduction attributable to P is 50% (P's deduction of its Year 1 current year BIE, \$150x, divided by the group's aggregate current year BIE deduction for Year 1, \$300x). Thus, the amount of domestic related current year BIE deduction status allocated to P is \$75x (the group's domestic related current year BIE deduction, \$150x, multiplied by the percentage of current year BIE deduction allocable to P, 50%); and the amount of foreign related current year BIE deduction status allocated to P is \$75x (the group's foreign related current year BIE deduction, \$150x, multiplied by the percentage of current year BIE deduction allocable to P, 50%).

(2) *Allocations to S1 and S2.* The percentage of current year BIE deduction attributable to S1 is 25% (S1's deduction of its Year 1 current year BIE, \$75x, divided by the group's aggregate current year BIE deduction for Year 1, \$300x). Thus, the amount of domestic related current year BIE deduction status allocated to S1 is \$37.5x (the group's domestic related current year BIE deduction, \$150x, multiplied by the percentage of current year BIE deduction allocable to S1, 25%); and the amount of foreign related current year BIE deduction status allocated to S1 is \$37.5x (the group's foreign related current year BIE deduction, \$150x, multiplied by the percentage of current year BIE deduction allocable to S1, 25%). Because S2 also deducted \$75 of its Year 1 current year BIE, S2's deductions are allocated the same pro-rata status as those of S1 under this paragraph (f)(2)(ii)(C)(2).

(D) *Application of the allocation rule in paragraph (c)(5) of this section.* Although the group will have disallowed BIE carryforwards after Year 1 (the group's aggregate current year BIE of \$450x (\$150x + \$150x + \$150x) exceeds the section 163(j) limitation of \$300x), all of the domestic related current year BIE and foreign related current year BIE in Year 1 has been taken into account pursuant to the classification rule in paragraph (c)(3) of this section. Thus, under paragraph (c)(5)(iv) of this section, each member's disallowed BIE carryforward is treated as from payments or accruals to unrelated parties.

(3) *Example 3: Business interest expense subject to section 163(j)—(i) The group's domestic related current year BIE and foreign related current year BIE for the year exceeds its section 163(j) limitation. (A) Facts.* During the current year (Year 1), P incurred \$60x of business interest expense to domestic related parties; S1 incurred \$40x of business interest expense to foreign related parties; and S2 incurred \$80x of business interest expense to unrelated parties. The group's section 163(j) limitation for the year is \$60x. After applying

the rules in § 1.163(j)–5(b)(3), the group deducts \$20x each of P, S1, and S2's current year business interest expense. Assume the group is an applicable taxpayer for purposes of section 59A.

(B) *Analysis*—(1) *Application of the absorption rule in paragraph (c)(2) of this section.* Following the rules in section 163(j), the group's section 163(j) interest deduction is \$60x, and the entire amount is from members' Year 1 business interest expense.

(2) *Application of the classification rule in paragraph (c)(3) of this section.* Under paragraph (c)(3) of this section, the group's \$60x of aggregate current year BIE deduction is first classified as payments or accruals to related parties (pro-rata among domestic related parties and foreign related parties), and second as payments or accruals from unrelated parties. The group's total related party interest expense in Year 1, \$100x (sum of the group's Year 1 domestic related current year BIE, \$60x, and the group's Year 1 foreign related current year BIE, \$40x), exceeds the group's aggregate current year BIE deduction of \$60x. Thus, the group's aggregate current year BIE deduction will be classified, pro-rata, as from payments or accruals to domestic related parties and foreign related parties. Of the group's aggregate current year BIE deduction in Year 1, \$36x is classified as a domestic related current year BIE deduction (the group's aggregate current year BIE deduction, \$60x, multiplied by the ratio of domestic related current year BIE over the group's total Year 1 related party interest expense (\$60x/(\$60x + \$40x))); and \$24x of the group's aggregate current year BIE deduction is classified as a foreign related current year BIE deduction (the group's section 163(j) interest deduction, \$60x, multiplied by the ratio of foreign related current year BIE over the group's total Year 1 related party interest expense (\$40x/(\$60x + \$40x))).

(3) *Application of the allocation rule in paragraph (c)(4) of this section.* After the application of the classification rule in paragraph (c)(3) of this section, the group has \$36x of domestic related current year BIE deduction and \$24x of foreign related current year BIE deduction from the group's aggregate current year BIE in Year 1. The domestic related current year BIE deduction and foreign related current year BIE deduction will be allocated to P, S1, and S2 based on each member's current year BIE deduction in Year 1.

(i) *Allocation of the group's domestic related current year BIE deduction status.* Because each member is deducting \$20x of its Year 1 business interest expense, all three members have the same percentage of current year BIE deduction attributable to them. The percentage of current year BIE deduction attributable to each of P, S1, and S2 is 33.33% (each member's current year BIE deduction in Year 1, \$20x, divided by the group's aggregate current year BIE deduction for Year 1, \$60x). Thus, the amount of domestic related current year BIE deduction status allocable to each member is \$12x (the group's domestic related current year BIE deduction, \$36x, multiplied by the percentage of current year BIE deduction allocable to each member, 33.33%).

(ii) *Allocations of the group's foreign related current year BIE deduction status.* The amount of foreign related current year BIE deduction status allocable to each member is \$8x (the group's foreign related current year BIE deduction, \$24x, multiplied by the percentage of current year BIE deduction allocable to each member, 33.33%, as computed earlier in paragraph (f)(3) of this section (*Example 3*)).

(4) *Application of the allocation rule in paragraph (c)(5) of this section.* In Year 1 the group has \$60x of domestic related current year BIE, of which \$36x is deducted in the year (by operation of the classification rule). Therefore, the group has \$24x of domestic related BIE carryforward. Similarly, the group has \$40x of foreign related current year BIE in Year 1, of which \$24x is deducted in the year. Therefore, the group has \$16x of foreign related BIE carryforward. The \$24x domestic related BIE carryforward status and \$16x foreign related BIE carryforward status will be allocated to P, S1, and S2 in proportion to the amount of each member's disallowed BIE carryforward.

(i) *Allocation to P.* The percentage of disallowed BIE carryforward allocable to P is 33.33% (P's Year 1 disallowed BIE carryforward, \$40x (\$60x – \$20x), divided by the group's Year 1 disallowed BIE carryforward, \$120x (\$60x + \$40x + 80x – \$60x)). Thus, the amount of domestic related BIE carryforward status allocated to P is \$8x (the group's domestic related BIE carryforward, \$24x, multiplied by the percentage of disallowed BIE carryforward allocable to P, 33.33%); and the amount of foreign related BIE carryforward status allocated to P is \$5.33x (the group's foreign related BIE carryforward, \$16x, multiplied by the percentage of disallowed BIE carryforward allocable to P, 33.33%). Under paragraph (c)(5)(iv) of this section, P's disallowed BIE carryforward that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party. Therefore, \$26.67x (\$40x P's disallowed BIE carryforward – \$8x domestic related BIE carryforward status allocated to P – \$5.33x foreign related BIE carryforward status allocated to P) is treated as interest paid or accrued to an unrelated party.

(ii) *Allocation to S1.* The percentage of disallowed BIE carryforward allocable to S1 is 16.67% (S1's Year 1 disallowed BIE carryforward, \$20x (\$40x – \$20x), divided by the group's Year 1 disallowed BIE carryforward, \$120x (\$60x + \$40x + 80x – \$60x)). Thus, the amount of domestic related BIE carryforward status allocated to S1 is \$4x (the group's domestic related BIE carryforward, \$24x, multiplied by the percentage of disallowed BIE carryforward allocable to S1, 16.67%); and the amount of foreign related BIE carryforward status allocated to S1 is \$2.67x (the group's foreign related BIE carryforward, \$16x, multiplied by the percentage of disallowed BIE carryforward allocable to S1, 16.67%). Under paragraph (c)(5)(iv) of this section, S1's disallowed BIE that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE

carryforward will be treated as interest paid or accrued to an unrelated party. Therefore, \$13.33x (\$20x S1's disallowed BIE carryforward – \$4x domestic related BIE carryforward status allocated to S1 – \$2.67x foreign related BIE carryforward status allocated to S1) is treated as interest paid or accrued to an unrelated party.

(iii) *Allocation to S2.* The percentage of disallowed BIE carryforward allocable to S2 is 50% (S2's Year 1 disallowed BIE carryforward, \$60x (\$80x – \$20x), divided by the group's Year 1 disallowed BIE carryforward, \$120x (\$60x + \$40x + 80x – \$60x)). Thus, the amount of domestic related BIE carryforward status allocated to S2 is \$12x (the group's domestic related BIE carryforward, \$24x, multiplied by the percentage of disallowed BIE carryforward allocable to S2, 50%); and the amount of foreign related BIE carryforward status allocated to S2 is \$8x (the group's foreign related BIE carryforward, \$16x, multiplied by the percentage of disallowed BIE carryforward allocable to S2, 50%). Under paragraph (c)(5)(iv) of this section, S2's disallowed BIE that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party. Therefore, \$40x (\$60x S2's disallowed BIE carryforward – \$12x domestic related BIE carryforward status allocated to S2 – \$8x foreign related BIE carryforward status allocated to S2) is treated as interest paid or accrued to an unrelated party.

(i) *The group deducting its disallowed BIE carryforwards*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(i)(A) of this section (the facts in *Example 3*(i)), and in addition, none of the members incurs any business interest expense in Year 2. The group's section 163(j) limitation for Year 2 is \$30x.

(B) *Analysis*—(1) *Application of the absorption rule in paragraph (c)(2) of this section.* Following the rules in section 163(j), each member of the group is deducting \$10x of its disallowed BIE carryforward from Year 1. Therefore, the group's section 163(j) deduction for Year 2 is \$30x.

(2) *Application of the classification rule in paragraph (c)(3) of this section.* Under paragraph (c)(3)(iv) of this section, to the extent members are deducting their Year 1 disallowed BIE carryforward in Year 2, the classification rule will apply to the deduction in Year 2 after the allocation rule in paragraph (c)(5) of this section has allocated the related and unrelated party status to the member's disallowed BIE carryforward in Year 1. The allocation required under paragraph (c)(5) of this section is described in paragraph (f)(3)(i)(B)(4) of this section.

(i) *Use of P's allocated domestic related BIE carryforward status and foreign related BIE carryforward status.* P has \$40x of Year 1 disallowed BIE carryforward, and P was allocated \$8x of domestic related BIE carryforward status and \$5.33x of foreign related BIE carryforward status. In Year 2, P deducts \$10x of its Year 1 disallowed BIE carryforward. Under the classification rule of paragraph (c)(3) of this section, P is treated as deducting pro-rata from its allocated status

of domestic related BIE carryforward and foreign related BIE carryforward. Therefore, P is treated as deducting \$6x of its allocated domestic related BIE carryforward ( $\$10x \times \$8x/(\$8x + \$5.33x)$ ), and \$4x of its allocated foreign related BIE carryforward ( $\$10x \times \$5.33x/(\$8x + \$5.33x)$ ). After Year 2, P has remaining \$30x of Year 1 disallowed BIE carryforward, of which \$2x has a status of domestic related BIE carryforward, \$1.33x has the status of foreign related BIE carryforward, and \$26.67x of interest treated as paid or accrued to unrelated parties.

(ii) *Use of S1's allocated domestic related BIE carryforward status and foreign related BIE carryforward status.* S1 has \$20x of Year 1 disallowed BIE carryforward, and S1 was allocated \$4x of domestic related BIE carryforward status and \$2.67x of foreign related BIE carryforward status. In Year 2, S2 deducts \$10x of its Year 1 disallowed BIE carryforward. Because S2's deduction of its Year 1 disallowed BIE carryforward, \$10x, exceeds its allocated domestic related BIE carryforward status (\$4x) and foreign related BIE carryforward status (\$2.67x), all of the allocated related party status are used up. After Year 2, all of S1's Year 1 disallowed BIE carryforward, \$10x, is treated as interest paid or accrued to an unrelated party.

(iii) *Use of S2's allocated domestic related BIE carryforward status and foreign related BIE carryforward status.* S2 has \$60x of Year 1 disallowed BIE carryforward, and S2 was allocated \$12x of domestic related BIE carryforward status and \$8x of foreign related BIE carryforward status. In Year 2, S2 deducts \$10x of its Year 1 disallowed BIE carryforward. Under the classification rule of paragraph (c)(3) of this section, S2 is treated as deducting \$6x of its allocated domestic related BIE carryforward ( $\$10x \times \$12x/(\$12x + \$8x)$ ), and \$4x of its allocated foreign related BIE carryforward ( $\$10x \times \$8x/(\$12x + \$8x)$ ). After Year 2, P has remaining \$50x of Year 1 disallowed BIE carryforward, of which \$6x has a status of domestic related BIE carryforward, \$4x has the status of foreign related BIE carryforward, and \$40x of interest treated as paid or accrued to unrelated parties.

(h) *Applicability date.* This section applies to taxable years for which the original consolidated Federal income tax return is due (without extensions) after December 6, 2019.

■ **Par. 9.** Section 1.1502-100 is amended by revising paragraph (b) to read as follows:

**§ 1.1502-100 Corporations exempt from tax.**

\* \* \* \* \*

(b) The tax liability for a consolidated return year of an exempt group is the tax imposed by section 511(a) on the consolidated unrelated taxable income for the year (determined under paragraph (c) of this section), and by allowing the credits provided in § 1.1502-2(b).

\* \* \* \* \*

■ **Par. 10.** Section 1.6038A-1 is amended by

■ 1. Re-designating paragraph (n)(2) as paragraph (n)(2)(i) and adding a subject heading for newly re-designated paragraph (n)(2)(i).

■ 2. Adding a sentence to the end of newly re-designated paragraph (n)(2)(i).

■ 3. Adding paragraph (n)(2)(ii).

■ 4. Revising the last sentence of paragraph (n)(3).

The additions and revision read as follows:

**§ 1.6038A-1 General requirements and definitions.**

\* \* \* \* \*

(n) \* \* \*

(2) *Section 1.6038A-2—(i) In general.*

\* \* \* Section 1.6038A-2(a)(3), (b)(6), and (b)(7) apply to taxable years ending on or after December 17, 2018. However, taxpayers may apply these final regulations in their entirety for taxable years ending before December 17, 2018.

(ii) *Transition rule.* No penalty under sections 6038A(d) or 6038C(c) will apply to a failure solely under § 1.6038A-2(a)(3), (b)(6), or (b)(7) that is corrected by March 6, 2020.

(3) \* \* \* For taxable years ending on or before December 31, 2017, see § 1.6038A-4 as contained in 26 CFR part 1 revised as of April 1, 2018.

\* \* \* \* \*

■ **Par. 11.** Section 1.6038A-2 is amended by

■ 1. Revising the subject headings for paragraphs (a) and (a)(1).

■ 2. Adding paragraph (a)(2).

■ 3. Adding paragraph (a)(3).

■ 4. Revising paragraphs (b)(1)(ii), (b)(2)(iv), and the second sentence of paragraph (b)(3).

■ 5. Redesignating paragraphs (b)(6) through (9) as paragraphs (b)(8) through (11).

■ 6. Adding new paragraphs (b)(6) and (7).

■ 7. Revising paragraph (c) and the first sentence of paragraph (d).

■ 8. Removing the language “Paragraph (b)(8)” from the second sentence of paragraph (g) and adding the language “Paragraph (b)(10)” in its place.

■ 9. Adding three sentences to the end of paragraph (g).

The revisions and additions read as follows:

**§ 1.6038A-2 Requirement of return.**

(a) *Forms required—(1) Form 5472.*

\* \* \*

(2) *Reportable transaction.* A reportable transaction is any transaction of the types listed in paragraphs (b)(3) and (4) of this section, and, in the case of a reporting corporation that is an applicable taxpayer, as defined under § 1.59A-2(b), any other arrangement that, to prevent avoidance of the

purposes of section 59A, is identified on Form 5472 as a reportable transaction. However, except as the Secretary may prescribe otherwise for an applicable taxpayer, the transaction is not a reportable transaction if neither party to the transaction is a United States person as defined in section 7701(a)(30) (which, for purposes of section 6038A, includes an entity that is a reporting corporation as a result of being treated as a corporation under § 301.7701-2(c)(2)(vi) of this chapter) and the transaction—

(i) Will not generate in any taxable year gross income from sources within the United States or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, and

(ii) Will not generate in any taxable year any expense, loss, or other deduction that is allocable or apportionable to such income.

(3) *Form 8991.* Each reporting corporation that is an applicable taxpayer, as defined under § 1.59A-2(b), must make an annual information return on Form 8991. The obligation of an applicable taxpayer to report on Form 8991 does not depend on applicability of tax under section 59A or obligation to file Form 5472.

(b) \* \* \*

(1) \* \* \*

(ii) The name, address, and U.S. taxpayer identification number, if applicable, of all its direct and indirect foreign shareholders (for an indirect 25-percent foreign shareholder, explain the attribution of ownership); whether any 25-percent foreign shareholder is a surrogate foreign corporation under section 7874(a)(2)(B) or a member of an expanded affiliated group as defined in section 7874(c)(1); each country in which each 25-percent foreign shareholder files an income tax return as a resident under the tax laws of that country; the places where each 25-percent shareholder conducts its business; and the country or countries of organization, citizenship, and incorporation of each 25-percent foreign shareholder.

\* \* \* \* \*

(2) \* \* \*

(iv) The relationship of the reporting corporation to the related party (including, to the extent the form may prescribe, any intermediate relationships).

(3) \* \* \* The total amount of such transactions, as well as the separate amounts for each type of transaction described below, and, to the extent the form may prescribe, any further

description, categorization, or listing of transactions within these types, must be reported on Form 5472, in the manner the form or its instructions may prescribe. \* \* \*

\* \* \* \* \*

(6) *Compilation of reportable transactions across multiple related parties.* A reporting corporation must, to the extent and in the manner Form 5472 or its instructions may prescribe, include a schedule tabulating information with respect to related parties for which the reporting corporation is required to file Forms 5472. The schedule will not require information (beyond totaling) that is not required for the individual Forms 5472. The schedule may include the following:

(i) The identity and status of the related parties;

(ii) The reporting corporation's relationship to the related parties;

(iii) The reporting corporation's reportable transactions with the related parties; and

(iv) Other items required to be reported on Form 5472.

(7) *Information on Form 5472 and Form 8991 regarding base erosion payments.* If any reporting corporation is an applicable taxpayer, as defined under § 1.59A-2(b), it must report the information required by Form 8991 and by any Form 5472 it is required to file (including the information required by their accompanying instructions), regarding:

(i) Determination of whether a taxpayer is an applicable taxpayer;

(ii) Computation of base erosion minimum tax amount, including computation of regular tax liability as adjusted for purposes of computing base erosion minimum tax amount;

(iii) Computation of modified taxable income;

(iv) Base erosion tax benefits;

(v) Base erosion percentage calculation;

(vi) Base erosion payments;

(vii) Amounts with respect to services as described in § 1.59A-3(b)(3)(i), including a breakdown of the amount of the total services cost and any mark-up component;

(viii) Arrangements or transactions described in § 1.59A-9;

(ix) Any qualified derivative payment, including:

(A) The aggregate amount of qualified derivative payments for the taxable year; and

(B) A representation that all payments satisfy the requirements of § 1.59A-6(b)(2); and

(x) Any other information necessary to carry out section 59A.

\* \* \* \* \*

(c) *Method of reporting.* All statements required on or with the Form 5472 or Form 8991 under this section and § 1.6038A-5 must be in the English language. All amounts required to be reported under paragraph (b) of this section must be expressed in United States currency, with a statement of the exchange rates used, and, to the extent the forms may require, must indicate the method by which the amount of a reportable transaction or item was determined.

(d) \* \* \* A Form 5472 and Form 8991 required under this section must be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. \* \* \*

\* \* \* \* \*

(g) \* \* \* Paragraph (b)(7)(ix) of this section applies to taxable years beginning June 7, 2021. Before these final regulations are applicable, a taxpayer will be treated as satisfying the

reporting requirement described in § 1.59A-6(b)(2) only to the extent that it reports the aggregate amount of qualified derivative payments on Form 8991. See § 1.59A-6(b)(2)(iv) (transition period for qualified derivative payment reporting).

#### § 1.6038A-4 [Amended]

■ **Par. 12.** For each paragraph listed in the table, remove the language in the "Remove" column from wherever it appears and add in its place the language in the "Add" column as set forth below and in paragraph (f), designate Examples 1 and 2 as paragraphs (f)(1) and (2), respectively.

Paragraph	Remove	Add
(a)(1) .....	\$10,000	\$25,000
(a)(3) .....	10,000	25,000
(d)(1) .....	10,000	25,000
(d)(4) .....	10,000	25,000
(f) .....	10,000	25,000
(f) .....	30,000	75,000
(f) .....	90,000	225,000

#### § 1.6655-5 [Amended]

■ **Par. 13.** Section 1.6655-5 is amended in paragraph (e) by designating Examples 1 through 13 as paragraphs (e)(1) through (13), respectively, and by removing the language "§ 1.1502-2(h)" in newly designated paragraph (e)(10) and adding the language "§ 1.1502-1(h)" in its place.

**Sunita Lough,**

*Deputy Commissioner for Services and Enforcement.*

Approved: November 13, 2019.

**David J. Kautter,**

*Assistant Secretary of the Treasury (Tax Policy).*

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