IRS Publishes Proposed Regulations on BEAT

On December 13, 2018, the IRS published proposed regulations (REG-104259-18) on the Base Erosion and Anti-Abuse Tax (the "BEAT"), a new tax regime under the Tax Cuts and Jobs Act ("TCJA"). BEAT is designed to discourage multinational corporations from profit-shifting behavior by making deductible payments to their foreign affiliates, such as interest, high-margin service payments, rents and royalties. While the proposed regulations shed light on the implementation mechanism of BEAT, there are some unwelcome surprises and open questions that taxpayers should be aware of.

In essence, BEAT imposes a maximum of a 12.5% tax on base erosion payments a taxpayer corporation makes to its foreign affiliates, which are deemed to be related parties if the ownership overlap with the taxpayer is greater than 25%. BEAT does not apply to real estate investment companies, real estate investment trusts, and S corporations. Whether BEAT applies is determined by the base erosion percentage. This base erosion percentage is computed by dividing the aggregate amount of base erosion tax benefits by the sum of the aggregate amount of deductions plus other base erosion tax benefits. Base erosion tax benefits are generally the deductions or reductions in gross income that result from base erosion payments.[1]

Corporations with over $500 million annual gross receipts for the three preceding taxable years that have base erosion percentage of 3% or more are subject to BEAT at a graduated rate, starting at 5% in 2018 and eventually up to the maximum of 12.5% by 2025. The amount of BEAT owed is determined based on the amount of base erosion payments, which in turn gives rise to annual base erosion tax benefits. Generally, the higher a taxpayer's base erosion payment amount is, the higher the BEAT liability will be. The proposed regulations are to apply to tax years beginning after December 31, 2017, and are expected to bring in $149.6 billion from applicable taxpayers over the 2018–2027 period.[2]

The regulations define what are considered as "base erosion payments." If an applicable corporation makes any of the following four types of payments to related foreign parties, the amount will be includable as base erosion payment, minus allowable deductions:
(1) payments to foreign related parties to which deductions are available;
(2) payments through which a taxpayer acquires depreciable or amortizable property;
(3) certain reinsurance payments to a foreign related party; and
(4) any payment that reduces gross receipts of a taxpayer with respect to "surrogate foreign corporations" or related foreign persons.[3]

The second category of base erosion payments—the acquisition of depreciable or amortizable property—creates a potential liability for U.S. corporations that engage in non-cash transactions. One of the operating rules of the proposed regulations states that a base erosion payment may consist of "any form of consideration," including "cash, property, stock or the assumption of liability."[4] Therefore, a domestic corporation may be liable for base erosion payments when it acquires depreciable or amortizable property from a foreign related party in exchange

[1] Prop. Treas. Reg. §1.59A-2(e)
[2] https://www.taxnotes.com/tax-reform/economic-analysis-can-marked-services-skip-beat
[3] Prop. Treas. Reg. §1.59A-3(b).
[4] Prop. Treas. Reg. §1.59A-3(b).

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of stocks in otherwise tax-free transactions, such as a Section 351 exchange, a Section 332 liquidation, or a Section 368 reorganization, even though the tax-free transactions are conducted with legitimate business purpose and in line with the TCJA's policy objective of encouraging on-shoring of income-producing assets.

There are several exclusions from base erosion payments that are favorable to taxpayers, such as the cost of goods sold, pre-effective date net operating losses, and payments to foreign related parties where the foreign affiliate is subject to tax in the U.S. on a net basis, to name a few. One of the most notable of such exclusions is the exclusion of payments that correspond to the cost component of low-margin services. The service cost method (SCM) exemption allows exclusion of cost of service from base erosion payment calculation, if the service is eligible for the SCM under Section 482, and the cost does not include any markup. If the total cost of the service, which is eligible for SCM, includes a markup, only the cost component of the payment is excludable, assuming the taxpayer meets record-keeping requirements to verify the amount paid for services, the total cost incurred by the service provider, and the allocation and apportionment of costs to services. Any portion that constitutes profit will be considered as a base erosion payment,

The proposed regulations set out three broad anti-abuse provisions to discourage taxpayers from engaging in transactions that have a principal purpose of avoiding BEAT. First, payments made through intermediaries to foreign related parties will be treated as base erosion payments or the role of the intermediary will be disregarded, if certain conditions are met (the payment would have been a base erosion payment if made directly to the foreign related party, the intermediary made corresponding payment to a foreign related party, or the transaction was principally motivated to avoid BEAT). Second, if a transaction, or a component of a transaction, is deliberately designed to increase deductions to reduce a taxpayer's BEAT liability, such deductions will be disregarded when calculating the base erosion percentage. Third, if a principal purpose of a transaction, plan or arrangement among related parties is to avoid BEAT rules applicable to financial institutions, they will not be taken into account. Lastly, Treasury is given broad regulatory authority to make any adjustments "necessary to prevent avoidance of the purpose of this section."

The complex and ambitious BEAT regime is in line with the global effort to curve large multinational corporations' tax avoidance strategy by exploiting discrepancies between tax jurisdictions. In Europe, the OECD and the EU have been aggressively combatting tax avoidance: OECD members are implementing the base erosion and profit shifting (BEPS) initiative. The EU's Code of Conduct Group investigated tax practices of 92 jurisdictions in 2017, which encouraged certain tax jurisdictions to adopt stricter requirements on multinational corporations operating there. Other jurisdictions such as the Netherlands are implementing similar policy changes in order to improve their tax reputations. The United Nations also launched initiatives to foster automatic information exchange for tax purposes between developed and developing countries. As national and global tax regimes move toward more complex and strict regulation of international tax planning, multinational corporations will benefit substantially from bringing their transactions into compliance.

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