KPMG report: Analysis and observations about "BEAT" proposed regulations

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Contents

On December 13, 2018, the Treasury Department and IRS released proposed regulations (REG 104259-18) under section 59A, which was enacted as part of the new Tax Cuts and Jobs Act (Pub. L. No. 115-97) (also referred to as the “new law”).

Effective dates and reliance

The proposed rules generally are proposed to apply to taxable years beginning after December 31, 2017, citing the authority for regulations issued within 18 months of the date of the enactment of a new statute to apply retroactively to the effective date of the statutory provision to which the regulation relates. Notably, and perhaps in recognition of the advancing calendar, the preamble also addresses the possibility of the proposed rules not being finalized within the 18-month window, by providing that Treasury and the IRS generally expect that any provision of the proposed regulations that is finalized after June 22, 2019, would apply to taxable years ending on or after the date the proposed regulations are filed with the Federal Register.

The proposed regulations were filed with the Federal Register, on December 17, 2018. This would allow the proposed regulations to apply to taxpayer years ending on December 31, 2018. It is also noteworthy, however, that the preamble does not discuss the impact of section 1503(a), which generally requires that any special consolidated return rules must be adopted by the un-extended due date of the return in order to retroactively apply.

Prior to finalization, taxpayers are permitted to rely on the proposed regulations for years beginning after December 31, 2017, provided the taxpayer and all related parties consistently apply the proposed regulations for all such taxable years that end before the regulations are finalized. Significantly, this phrasing suggests that changes between proposed and final regulations may be made fully retroactive.

Comment period and hearing

The preamble to the proposed rules includes over 20 requests for comment; any comments or requests for a public hearing must be submitted within 60 days after the date of publication in the Federal Register.

Background

New section 59A imposes an addition to tax (the “base erosion and anti-abuse tax” or “BEAT”) that targets certain deductions or similar tax benefits (“base erosion tax benefits”) attributable to “base erosion payments” made to foreign related parties by certain “applicable taxpayers.” An applicable taxpayer is a corporation (other than an S Corporation, a regulated investment company, or a real estate investment trust) that has average annual gross receipts of at least $500 million for the 3-taxable-year period ending with the preceding taxable year, and has a “base erosion percentage” (generally the ratio of base erosion tax benefits over the aggregate deductions (with limited exceptions) allowable to the taxpayer during the taxable year) in excess of 3%. The base erosion percentage threshold is dropped to 2% in the case of taxpayers that are members of affiliated groups containing a bank or registered securities dealer.

The BEAT acts as a minimum tax that applies to the extent that a tentative BEAT calculated on "modified taxable income" exceeds regular tax liability. For these purposes, modified taxable income generally is calculated like taxable income, but with no deduction allowed for (i) "base erosion tax benefits" attributable to base erosion payments to foreign related parties, or (ii) a portion of the net operating loss ("NOL") deduction allowed during the taxable year. In addition, the tentative BEAT is calculated without giving any benefit for credits, whereas the regular tax liability to which this amount is compared generally is calculated after taking into account the effect of credits, including the foreign tax credit, with only limited exceptions for taxable years beginning before 2026 for the R&D credit and certain section 38 credits. The lack of a foreign tax credit under the BEAT makes it imperative for many taxpayers to keep their base erosion percentage below the applicable threshold.

The BEAT applies at a 5% rate for taxable years beginning in 2018, 10% for taxable years beginning in 2019 through 2025, and 12.5% for taxable years beginning in 2026 or later. The rate is one percent higher for any taxpayer that is a member of an affiliated group that includes a bank or registered securities dealer.

Overview

The proposed BEAT regulations provide guidance on a wide range of issues, including which taxpayers will be subject to section 59A (including guidance on how to determine gross receipts and base erosion percentage); the scope of what is included as a base erosion payment and a base erosion tax benefit; and the method for calculating modified taxable income and the base erosion minimum tax amount. The proposed rules also provide guidance on reporting requirements, the application to consolidated groups and partnerships, and the interaction with the interest expense limitation under section 163(j). The following features of the proposed rules, which are discussed in greater detail below, appear particularly noteworthy:

- **Application of section 15.** The proposed regulations provide that for taxable years beginning after January 1, 2018, section 15 will apply to any taxpayer using a taxable year other than the calendar year. The reference to section 15 is unclear. It at least implies that the section 15 blended rate regime applies to fiscal year filers for tax years beginning in 2018 and taking into account the change in the BEAT rate from 5% to 10%. Thus, for example, if section 15 applies to an 11/30 taxpayer, the resulting blended BEAT rate would be 9.58% for the tax year end 11/30/19. As noted in more detail below, this result is not completely clear from the proposed regulations themselves, and appears inconsistent with the structure of the BEAT statute.

- **Add-back approach for modified taxable income ("MTI") calculation.** The BEAT statute could be read to contemplate a full recalculation of taxable income in order to arrive at MTI. The proposed rules provide instead that MTI is computed by starting from taxable income or loss as computed for regular income tax purposes, and then simply adding back any gross base erosion tax benefits and the base erosion percentage of the NOL deduction allowed under section 172 for the tax year. This means, for example, that the amount of interest allowed under section 163(j) would not be redetermined to take into account any increase to MTI.

- **Treatment of NOLs for BEAT purposes.** The proposed rules provide that the base erosion percentage applicable to NOLs for purposes of the MTI calculation is the percentage associated with the “vintage” year in which the NOL was incurred, rather than the base erosion percentage associated with the year in which the NOL is applied to reduce taxable income. This has the effect of treating the base erosion percentage of an NOL that arose in a taxable years beginning before January 1, 2018, as zero. In addition, with respect to pre-2018 NOLs, the proposed rules would limit the amount of the NOL that can be taken into account for BEAT purposes to the amount that is necessary to reduce regular taxable income to zero ($0). Thus, while a current year loss would result in negative taxable income as a starting point for the MTI calculation, an NOL would not reduce taxable income below zero for that purpose.

- **Broad scope of “amounts paid or accrued.”** The proposed rules provide that an “amount paid or accrued” for purposes of defining a base erosion payment subject to the BEAT is not limited to cash payments, and would also include amounts paid or accrued using any other form of consideration including property, stock or the assumption of a liability. The preamble to the proposed rules notes that no exception is provided for transactions eligible for nonrecognition treatment.

- **Services cost method (“SCM”) exception.** Consistent with the position taken by KPMG tax professionals, the proposed rules provide that the exception for services that are eligible to be priced using the services cost method under section 1.482-9(b), but for the business judgment rule in section 1.482-9(b)(5), is available even when a mark-up is charged; in such case, only the portion of the payment exceeding the total services cost will not be eligible for the exception. The proposed rules provide books and records requirements that apply for purposes of the SCM exception.

- **Aggregation rule.** The BEAT statute provides for an aggregation rule treating members of the same controlled group as a single person for purposes of determining whether a taxpayer is an applicable taxpayer and what base erosion percentage will apply to that taxpayer. The proposed rules clarify that the aggregation rule will exclude foreign members of the controlled group except to the extent that they are subject to U.S. income taxation on their net income. The proposed rules also provide rules for calculating gross receipts and the base erosion percentage of an aggregate group, including rules for an aggregate group that includes taxpayers with different tax years.

- **ECI exception.** The proposed rules provide an exception from the scope of base erosion payments for amounts that are subject to tax on a net basis in the United States because they are treated as effectively connected with a trade or business or as profits attributable to a permanent establishment under a U.S. tax treaty.

- **Interaction with section 163(j).** The proposed rules reverse the rule announced in Notice 2018-28 for section 163(j) carryforwards from pre-effective date tax years. The proposed rules provide that such interest would not constitute a base erosion payment when allowed. The proposed rules also provide detailed rules regarding the interaction with section 163(j), including how to classify the remaining interest for which deductions are allowed when section 163(j) applies (e.g., as paid to related or unrelated, U.S. or foreign, persons).

- **Qualified derivative payments.** The proposed rules narrow the BEAT statute's broad definition of derivatives by removing securities lending transactions, sale-repurchase transactions, and substantially similar transactions from the scope of derivatives covered by the exception. The proposed rules also include reporting requirements that apply with respect to QDPs, and address the effect of noncompliance.

- **Allocation of expenses.** The proposed rules provide that a foreign corporation with interest or other expenses allocable to effectively connected income will be treated as making base erosion payments to the extent the expense results from a payment or accrual to a foreign related party. In the case of interest, the proposed rules provide that the allocation would depend on the interest expense allocation method otherwise used by the taxpayer. Notably, in the case of a taxpayer relying on a tax treaty method that would recognize payments between a branch and a foreign home office for purposes of determining taxable profits, such payments would be treated as subject to the BEAT even though they are not otherwise recognized for U.S. tax purposes.

- **Aggregate approach to partnerships.** The proposed rules generally adopt an aggregate approach for characterizing payments made to or by a partnership. That is, payments made by a partnership with corporate partners generally would be treated as made by those corporate partners. Consistent with this aggregate approach, whether a recipient of a payment is a foreign related person would also be determined at the partner level. The proposed rules also provide a new exception that would disregard allocations of base erosion tax benefits to de minimis partners.

Reporting requirements

The new law amended section 6038A to authorize regulations requiring reporting by corporations that are applicable taxpayers for BEAT purposes. The proposed rules identify information that will be required to be reported, along with the time and manner for such reporting. The proposed rules also provide that the IRS may require certain additional information reporting via forms or form instructions.

Anti-abuse rule

Section 59A(i) provides Treasury and the IRS with extremely broad anti-abuse authority, which raises significant questions about how taxpayers would be permitted to manage their BEAT liability. The proposed rules provide a number of specific anti-abuse rules addressing relatively narrow factual situations. In addition, the proposed rules provide more general anti-abuse rules focused on transactions, plans, or arrangements with a principal purpose of: (1) avoiding or reducing base erosion payments through the use of intermediaries; (2) increasing the deductions taken into account for purposes of the denominator of the base erosion percentage; and (3) avoiding the rules applicable to banks and registered securities dealers.

Applicable Taxpayer

In general

Section 59A applies to certain sizable taxpayer groups, for which so-called U.S. base erosion payments comprise a specified percentage of their deductible payments ("applicable taxpayers"). As stated above, section 59A(e) defines an applicable taxpayer as a corporation (other than a regulated investment company ("RIC"), real estate investment trust ("REIT"), or S corporation) or, as discussed further below, a controlled group of corporations that has both average annual gross receipts of at least $500 million for the three preceding taxable years (the "Gross Receipts Test"), and a base erosion percentage for the taxable year in excess of the applicable threshold (the "Base Erosion Percentage Test"). The proposed rules would expand the aggregation rules and provide operating rules for applying the Gross Receipts and Base Erosion Percentage Tests. The proposed rules also would provide rules applying the Applicable Taxpayer requirements in the partnership context.

Aggregation rules

For purposes of determining applicable taxpayer status, section 59A(e)(3) adopts a modified version of the section 1563(a) group rules, applying a 50% ownership threshold, to treat an "aggregate group" of corporations as one taxpayer. Once the aggregate group is determined, the proposed rules would require each taxpayer that is a member of the aggregate group to determine its gross receipts and base erosion percentage as of the end of its taxable year. To do so, each member must take into account the gross receipts and base erosion tax benefits of all of the members of the aggregate group. For these purposes, the proposed rules would eliminate payments between members of the aggregate group, so that a deductible intragroup payment would generate neither additional gross receipts nor tested deductions. As discussed further below, the proposed rules broadly take an aggregate approach to partnerships, and test partners' distributive shares of partnership items (gross receipts, deductions, etc.) at the partner level.

The proposed rules generally would exclude foreign corporations from the aggregate group, except with regard to transactions related to income that is, or is treated as, income effectively connected with the conduct of U.S. trade or business ("ECI"). If a foreign corporation qualifies for the benefits of a tax treaty, only transactions related to the net taxable income of a U.S. permanent establishment are taken into account.

KPMG observation: Under the proposed rules, all payments between domestic members of an aggregate group would be disregarded for purposes of the Gross Receipts and Base Erosion Percentage Tests. Note that this rule is applied on a transaction-by-transaction basis. Because foreign corporations are treated as members of the aggregate group only to the extent transactions are treated as giving rise to ECI (or included in determining net income under a treaty), the same foreign corporation may be considered a member of an aggregate group with respect to one transaction but not another. For example, assume that a foreign corporation (Foreign Parent) that is not located in a treaty jurisdiction wholly owns U.S. Subsidiary, and also has a U.S. trade or business subject to U.S. federal income tax on its net income. U.S. Subsidiary makes two deductible payments to Foreign Parent – one that is included in Foreign Parent's ECI and one that is not. Foreign Parent would be considered part of the aggregate group with respect to the ECI-related payment and, therefore, the payment would be disregarded in determining applicable taxpayer status. However, Foreign Parent would not be part of the aggregate group with respect to the non-ECI payment, and that payment would be taken into account for purposes of the Gross Receipts and Base Erosion Percentage Tests.

KPMG observation: Foreign financial institutions frequently conduct their U.S. business though both a U.S. branch of the foreign bank and a consolidated group of corporations that are generally required to be organized under a single U.S. entity. It is customary for frequent payments to be made between the U.S. branch and the members of the consolidated group, and there was a concern the ECI-related payments would be included in both the Gross Receipts and Base Erosion Percentage Tests. The proposed rules' aggregate approach should be welcome news for these institutions.

Notably, for aggregate groups that include members that are separate taxpayers (e.g., different U.S. consolidated groups) with different taxable years, the proposed rules would require each separate taxpayer to apply the Gross Receipts and Base Erosion Percentage Tests based on the aggregate group's data but computed with respect to the separate taxpayer's individual taxable year. That is, the proposed rules do *not* take the more common approach of referring to the taxable years of other taxpayers that end with or within the taxable year of the relevant taxpayer.

KPMG observation: These rules could cause aggregate group members with different taxable years to reach very different results with respect to their base erosion percentages and average annual gross receipts. The preamble states that the approach in the proposed rules is intended to provide certainty for taxpayers and to avoid the complexity of using a single taxable year for an aggregate group, yet this approach could create significant data collection and systems challenges for groups with numerous, separate U.S. taxpayers. The preamble appears to acknowledge these potential challenges by stating that taxpayers may use a reasonable method to determine the gross receipts and base erosion percentage information of members with different taxable years. This language does not, however, appear in the actual text of the proposed rules.

The regulations also would provide a transition rule for groups with members that have fiscal years beginning before January 1, 2018 and ending in 2018. The rule provides that each taxpayer must determine the scope of pre-effective date payments by using its own taxable year for all members of the taxpayer's aggregate group. Thus, a fiscal year taxpayer would only take into account amounts paid or accrued by the aggregate group during its first year in which section 59A is effective. Correlatively, a calendar year group member must take into account amounts paid or accrued by fiscal year group members during all of 2018, even if a portion of those amounts are pre-effective date payments with respect to those fiscal year members.

Partnership transactions

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

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

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

The proposed rules would provide a de minimis exception for purposes of determining the amount of a partner's base erosion tax benefits – but not for purposes of determining the partner's gross receipts. Under the exception, a partner would not be required to take into account its distributive share of any of the partnership's potential base erosion tax benefits for the taxable year if all three of the following requirements are satisfied: (i) 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; (ii) the partner is allocated less than ten percent of each partnership item of income, gain, loss, deduction, and credit for the taxable year; and (iii) the partner's interest in the partnership has a fair market value of less than $25 million on the last day of the partner's taxable year, determined using a reasonable method.

KPMG observation: The statute does not specifically address the treatment of partnerships. However, U.S. partnerships generally are treated as U.S. persons and foreign partnerships generally are treated as foreign persons for U.S. federal income tax purposes. As a result, a literal application of the statute could have produced BEAT liability on payments entirely within the U.S. tax system, and conversely could have ignored payments which were functionally outbound deductions to related parties. By taking an aggregate approach, the proposed rules would prevent the existence of a partnership (foreign or domestic) from producing different results than would have arisen had the partners entered into the transaction directly.

Gross receipts test

The proposed rules include a number of rules for purposes of applying the Gross Receipts Test, i.e., determining whether the average annual gross receipts of the aggregate group (with reference to that taxpayer's taxable period) for the prior three-taxable-year period are at least $500 million.

First, the proposed rules reference section 1.448-1T(f)(2)(iv) for the general definition of gross receipts. The gross receipts of a consolidated group are determined by aggregating the gross receipts of all of the members of the consolidated group (but eliminating intra-group payments). Consistent with the rule noted above, a foreign corporation's gross receipts include only gross receipts that are included in determining ECI or, under an applicable tax treaty, in net taxable income attributable to a U.S. permanent establishment. For any corporation that is subject to tax under subchapter L (or any corporation that would be subject to tax under subchapter L if that corporation were a domestic corporation), gross receipts are reduced by return premiums, but are not reduced by any reinsurance premiums paid or accrued.

The proposed rules also provide operating rules for a variety of extraordinary events (such as mergers) occurring during the three year testing period. In the context of a section 381(a) transaction in which the taxpayer was the acquiring corporation, the proposed rules would apply the gross receipts test by including any predecessor to the taxpayer (the "predecessor rule"). In addition, any taxpayer with a taxable year of less than 12 months is required to annualize its gross receipts from the short period (the "annualization rule"). Finally, any taxpayer not in existence for the entire three-year testing period must determine its average annual gross receipts for the period that it was in existence, taking into account the annualization rule (the "short testing period rule").

KPMG observation: Although the proposed rules do not clearly provide an ordering protocol among the three special rules, it seems reasonable to apply the precedessor rule first, then to apply the annualization rule, and finally to apply the short testing period rule. Consequently, the data for predecessor and successor corporations are first combined, and annualization would only apply if there is any remaining short year during the testing period. If the taxpayer still has fewer than three prior taxable years in the testing period, the average annual gross receipts are calculated only with respect to those years the taxpayer was in (or, under the annualization rule, is treated as in) existence.

Base erosion percentage test

Base erosion percentage threshold

Under section 59A(e), a taxpayer generally satisfies the Base Erosion Percentage Test if the taxpayer has a base erosion percentage (calculated under the aggregation rules discussed above) of three percent or more.

As a general matter, an aggregate group that includes a member of an affiliated group (as defined in section 1504(a)(1)) that includes a domestic bank or a registered securities dealer is subject to a two percent threshold. The proposed rules would include a de minimis exception that turns off the lower, two percent threshold for a taxable year if the total gross receipts of the aggregate group that are attributable to the bank or the registered securities dealer represent less than two percent of the total gross receipts of the aggregate group. The de minimis rule applies to a consolidated group, if there is no aggregate group.

KPMG observation: This rule likely will provide welcome relief for groups that primarily conduct a non-financial services business but own a small bank within their affiliated group. For example, a number of large retailers own small banks that provide limited banking services to their customers (e.g., credit card services). Further, taxpayers otherwise subject to the three percent threshold may not be negatively impacted if they acquire a target group that includes a small bank or registered securities dealer.

The proposed rules also would clarify that only corporations satisfying the requirements of section 581 are treated as a “bank”. Among other requirements, section 581 provides that a bank must be incorporated and doing business under the laws of the United States (including laws related to the District of Columbia) or any state. Therefore, foreign financial institutions that only operate in the United States through a U.S. branch would not be treated as a bank for these purposes.

Base erosion percentage calculation

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

- The aggregate amount of base erosion tax benefits (the “numerator”), divided by
- An amount (the “denominator”) equal to:
  - o The aggregate amount of the taxpayer’s allowable deductions as well as certain base erosion tax benefits arising from reductions to gross income (described below);

- o Reduced by

  - – Deductions allowed under sections 172 (NOLs), 245A (participation exemption), or 250 (FDII and GILTI);

  - – Deductions for payments for services that qualify for the SCM Exception; and

  - – Deductions for payments that qualify for the QDP Exception.

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

The proposed rules provide several taxpayer-favorable rules for calculating the base erosion percentage. The proposed rules would clarify that the numerator does not include deductible payments to related foreign persons that qualify for one of the exceptions to the definition of a base erosion payment. In addition, the proposed rules would include in the denominator an amount paid to a related foreign person that is not a member of the aggregate group if the payment qualifies for the ECI Exception and the payment also qualifies for either the QDP Exception, TLAC Exception, or SCM Exception (all discussed further below). The preamble to the proposed rules also confirms that a deduction allowed under section 965(c) is included in the denominator, as it is not one of the categories of deductions specifically excluded from the denominator under the statute.

On the other hand, the proposed rules also would expand the list of items that are excluded from the denominator of the fraction to include: (i) any exchange loss from a section 988 transaction; (ii) any amounts that qualify for the TLAC Exception discussed below; and (iii) any deduction not allowed in determining taxable income for the taxable year.

Finally, the proposed rules would require a scaled inclusion of base erosion tax benefits related to payments subject to U.S. withholding tax. A base erosion tax benefit is not included in the numerator if the payment was subject to withholding tax under sections 871 or 881 (as non-ECI FDAP) and withholding has occurred. Full withholding (i.e., at the statutory rate) results in elimination of the full amount of the base erosion tax benefits from the numerator. Partial withholding, i.e., under an applicable income tax treaty, results in elimination of a proportionate amount of the base erosion tax benefits from the numerator. For example, a 10% withholding tax – imposition of 1/3 of the statutory withholding tax rate – eliminates 1/3 of the base erosion tax benefit from the numerator.

Mark-to-market deductions

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

KPMG observation: The proposed rules clarify the treatment of contracts subject to mark-to-market tax accounting. Taxpayers' systems may track these positions differently, particularly taxpayers that are not generally mark-to-market taxpayers (e.g., corporations that apply mark-to-market to hedging transactions). Additional flexibility in calculating income or loss from mark-to-market positions may be helpful.

KPMG observation: The proposed rules do not provide further clarity as to how to define a "transaction" that is marked-to-market for federal income tax purposes. Presumably, the determination should be made for each contract (e.g., ISDA confirmation, trade ticket).

KPMG observation: As discussed above, section 988 exchange losses from a section 988 transaction would be excluded from the denominator. Many foreign currency derivative contracts are marked-to-market for tax purposes (e.g., certain foreign currency forward contracts that are subject to section 1256 and derivatives referencing foreign currency that are subject to section 475). The losses on these contracts may qualify as section 988 exchange losses and would therefore need to be excluded from the denominator. This result is inconsistent with the statutory treatment of payments on other mark-to-market derivatives, which are only excluded from the denominator to the extent of the exclusion from the numerator. It is unclear why Treasury and the IRS provided this disparate treatment for section 988 losses, and in the preamble, the government requested comments on the treatment of section 988 losses in the denominator of the base erosion percentage calculation.

Base erosion payments

The BEAT statute defines a base erosion payment to include payments or accruals by a taxpayer to a foreign related party that fall into one of four categories: (i) payments for which a deduction is allowable; (ii) payments made in connection with the acquisition from the foreign related party of depreciable or amortizable property; (iii) premiums or other consideration paid for reinsurance, and (iv) certain payments with respect to a surrogate foreign corporation or its expanded affiliated group that result in a reduction of the taxpayer's gross receipts. Specifically excluded from this definition, however, are qualified derivative payments, as well as certain payments that would otherwise qualify for the service cost method (without regard to the so called "business judgment rule" in section 1.482-9(b)(5)).

The proposed rules provide operating rules for determining whether an amount is a base erosion payment, provide guidance on the scope of the statutory exceptions already in place, and add several new exceptions from the definition of base erosion payment.

Operating rules

As a preliminary matter, the proposed rules take an expansive view of the circumstances in which a base erosion payment may arise. In particular, Treasury clarified the types of consideration that may be treated as an "amount paid or accrued" to include not only payments made in cash and property, but also stock or the assumption of a liability. The preamble further notes that in some cases, a non-cash payment to a foreign party may meet the definition of a base erosion payment in the context of a transaction that qualifies under certain non-recognition provisions of the Code. The preamble lists as examples of such transactions 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 preamble notes that no specific exception is provided for transactions eligible for nonrecognition treatment, and includes a fairly extensive discussion of why Treasury and the IRS believe that to be the correct result, emphasizing that the statutory definition of a base erosion payment that results in the acquisition of depreciable or amortizable assets in exchange for a payment or accrual to a foreign related party is based on the amount of imported basis in the asset, which applies equally to carryover basis in a nonrecognition transaction. Although asserting the existence of a "payment" by the shareholder in a liquidation of its subsidiary, the preamble does acknowledge that the receipt of property by the shareholder in a non-liquidating distribution under section 301 is not a "payment" for BEAT purposes.

The preamble also suggests that, with respect to the first category of base erosion payments, a transfer of property to a foreign related party may constitute a base erosion payment if the transfer results in a deductible loss. The preamble requests comments on the appropriate treatment of non-cash consideration.

KPMG observation: In light of this broad view of what constitutes a base erosion payment, taxpayers should carefully consider the BEAT implications of internal restructurings resulting in inbound transfers of depreciable or amortizable property, including those involving only stock consideration. Taxpayers should also consider the BEAT implications of outbound sales or other transfers of assets to related parties that may result in a loss for U.S. tax purposes.

The proposed rules also provide that a taxpayer should determine its base erosion payments on a gross basis, regardless of any contractual right to settle obligations by offsetting amounts owed by one party against obligations owed to it by the other party.

The preamble notes, however, that where generally applicable U.S. tax law would allow the computation of deductions on a net basis, the proposed rules do not change that result. The preamble further notes that other existing general tax principles that may impact deductibility or that may exclude an item from gross income because it is beneficially owned by a different person generally will have consequences for Section 59A as well as for other provisions of the Code.

KPMG observation: Given the higher stakes under the BEAT on the classification of related party payments, now is a good time for taxpayers to revisit their existing arrangements with foreign related parties to determine which amounts are appropriately treated as deductions as opposed to other forms of transactions (such as partnerships, agency, or co-ownership of assets or income streams), taking into account the underlying contractual agreements and the application of general U.S. tax law principles for attribution of gross income. Taxpayers should also ensure that they consistently take into account the effect that positions taken with respect to the BEAT will have for general income tax purposes.

KPMG observation: The application of these rules in the context of cost-sharing arrangements under section 1.482-7 may be of particular interest to many taxpayers. The cost-sharing regulations provide that certain payments (“CST Payments”) from one participant to another are treated as reducing the recipient’s deductions for amounts it has paid (rather than being gross income to the recipient). This raises two related questions – first whether the related party payor should therefore be treated as directly making the payments for which the recipient’s deductions are reduced (for example under a deemed agency treatment), and second whether a similar treatment should apply for all expenses incurred pursuant to the cost-sharing arrangement (i.e., disaggregation) rather than just for CST Payments made between the parties. In public comments last week a Treasury official indicated that the cost-sharing regulations should not be read so broadly as to create that kind of deemed transaction in either context. Rather, the CST Payment should be respected as a deductible payment made to the recipient of the CST Payment and only in the amount of the CST Payment. All other amounts incurred in connection with the cost-sharing arrangement should be treated as payments by the participant that actually incurred the amounts and paid to the person actually receiving the amounts.

The proposed rules provide rules for foreign taxpayers with a U.S. trade or business or a permanent establishment to determine the amount of base erosion payments allocable against their effectively connected income or business profits. These rules distinguish between foreign taxpayers that calculate their taxable income by applying U.S. expense allocation rules and those that rely on a treaty to apply a method of expense allocation that differs from U.S. domestic tax rules (e.g. by allocating costs to the permanent establishment based on its assets used, risks assumed, and functions performed).

With respect to foreign taxpayers applying U.S. expense allocation rules, the proposed rules generally follow the approach in the current regulations for interest (section 1.882-5) and other deductions (section 1.882-4) incurred by a foreign person in the conduct of its U.S. trade or business. Any payments that are paid to a related foreign person that are allocated against the foreign corporation's ECI are generally treated as base erosion payments subject to an applicable exception. With respect to interest expense, the proposed rules provide detailed rules that differ in approach depending on whether a taxpayer uses the adjusted U.S. booked liabilities (AUSBL) method or the separate currency pools method under section 1.882-5. In general, a taxpayer will have base erosion payments based on the identity of the recipient of interest that is directly allocated to ECI (or that is paid with respect to U.S. booked liabilities for AUSBL taxpayers). Any remaining interest expense will be treated as base erosion payments in accordance with the ratio of the average worldwide liabilities due to foreign related parties over average total worldwide liabilities.

With regard to foreign taxpayers relying on an income tax treaty to attribute interest and other deductions on the basis of assets used, risks assumed, and functions performed, the proposed rules generally recognize amounts that are treated as deductible payments between the permanent establishment and the foreign corporation's home office or another branch of the foreign corporation for purposes of calculating attributable profit—referred to as internal dealings— as base erosion payments.

KPMG observation: Treating otherwise disregarded amounts between a U.S. branch and other parts of the same entity as payments to a related person stands in stark contrast to the allocation rule that applies to taxpayers applying section 1.882-5, which appears intended to limit base erosion payments to the U.S. branch's share of interest expense that the foreign corporation in fact pays to other persons that are foreign related parties.

As noted above, the proposed rules adopt an aggregate view of partnerships for purposes of identifying base erosion payments. In addition, the proposed rules provide rules deeming there to be base erosion payments in the case of certain payments to other "domestic passthrough" entities, including trusts, REITs, and RICs, that are owned in whole or in part by foreign related parties. An additional anti-abuse rule addresses certain transfers of depreciable or amortizable property between related parties.

KPMG observation: The rules addressing non-partnership domestic passthrough entities and transfers of property to related taxpayers appear to be intended to prevent taxpayers from converting base erosion payments into non-base erosion payments by using U.S. entities or entities that are not "applicable taxpayers" to "cleanse" the payments without giving up tax benefits.

Exceptions

The proposed rules clarify several questions related to certain exceptions to the definition of base erosion payment and also add several new exceptions.

- **SCM Exception:** Consistent with the view of KPMG's tax professional, the proposed rules clarify that outbound payments with respect to services that are otherwise eligible for the services cost method exception (without regard to the business judgment rule) (the “SCM exception”) would not be disqualified by the fact that a mark-up is charged on such payment. Instead, the cost component of the payment would continue to qualify for the SCM exception while the amount charged as a mark-up generally would constitute a base erosion payment. Helpfully, the proposed rules would confirm that an election to use the services cost method and the satisfaction of other reporting requirements relevant to the services cost method are not required to meet the SCM exception. However, the taxpayer would be required to maintain adequate books and records from which the IRS could verify the total amount of the payment and the total costs of the services.

- **QDP Exception:** The proposed rules also include guidance on the scope of the exception for qualified derivative payments (the “QDP exception”), including guidance on the associated reporting requirements. First, the contract pursuant to which the payment is made must constitute a “derivative” under the BEAT statute. The proposed rules provide that, because of their similarity to a secured loan, a sale-repurchase agreement and a securities lending transaction would not be treated as derivatives for purposes of the QDP exception. Treasury requests comments on whether excluding these transactions was appropriate. The proposed rules also would provide that ADRs and certain insurance contracts are not derivatives.

- Second, by its terms, the QDP exception only applies when the taxpayer satisfies certain reporting requirements, which raised concern among taxpayers that the misreporting of one derivative payment could forfeit the QDP exception for all derivative payments. Helpfully, the proposed rules would clarify that, if a taxpayer satisfies the reporting requirements for some, but not all, of its derivative payments, those payments that met the reporting requirements would continue to satisfy the QDP exception. In contrast to the general applicability date of the proposed rules, the reporting requirements for the QDP exception (section 1.6038A-2(b)(7)(ix)) are proposed to be effective for taxable years beginning one year after the final regulations are published in the Federal Register. Prior to that date, the reporting requirement will be treated as satisfied only to the extent the taxpayer reports the aggregate amount of qualified derivative payments on IRS Form 8991.

  KPMG observation: Eliminating the risk of a “cliff effect” if a taxpayer fails to satisfy the reporting requirements for some derivative contracts is welcome relief, along with the delayed effective date for the full reporting requirements. Further, excluding sale-repurchase transactions from the definition of a derivative is consistent with existing law that treats the arrangements as a secured borrowing. However, excluding securities lending transactions from the definition of a derivative is surprising given that the economics of a securities lending transaction, especially for the borrower of the security, closely resembles other derivative contracts (e.g., taking the short position on a total return swap).

In addition to the clarifications to the SCM and QDP exceptions, the proposed rules would add several new exceptions to the definition of base erosion payment.

- **ECI exception:** Most notably, the proposed rules would add an exception for outbound payments that are included in the foreign related corporation's income as ECI and subject to U.S. tax (the "ECI exception"). Notably, the ECI exception only applies to the extent that the taxpayer receives a withholding certificate from the foreign related corporation. Similarly, outbound payments made to a foreign corporation that determines its U.S. taxable income under an applicable U.S. treaty also are not included in the definition of base erosion payment to the extent such amounts are taken into account by the foreign corporation in determining its U.S. taxable income.

- **TLAC exception:** The proposed rules would add an exception for certain global systemically important banking organizations ("GSIB"s) that are required under U.S. law to issue a certain amount of TLAC securities to minimize the risk of insolvency (the "TLAC exception"). In particular, payments made on TLAC securities by a domestic intermediate holding company of a foreign GSIB to a related foreign party are excluded from the definition of base erosion payment. This exception is only available, however, to the extent of the amount of TLAC securities that are required by U.S. law. Notably, since the relevant U.S. laws associated with the TLAC exception only apply to domestic institutions, foreign corporations would not be entitled to avail themselves of the TLAC exception even when they are subject to similar solvency requirements in their home country. Comments were requested on whether a similar exception should apply to foreign corporations.

- **Exception for section 988 losses:** The proposed rules exclude from the definition of base erosion payment exchange losses with respect to section 988 transactions. This exclusion applies to all types of section 988 transactions, including physical currency, currency forwards and derivatives, and nonfunctional currency debt instruments. As noted above, such losses are also excluded from the denominator in calculating the base erosion percentage.

Finally, consistent with the statute, the proposed rules also would exclude from the definition of base erosion payment any amounts paid or accrued in taxable years prior to January 1, 2018. Contrary to the position set forth in Notice 2018-28, 2018-16 I.R.B. 492, the proposed rules also would exclude from the definition of base erosion payment disallowed interest under section 163(j) that is carried over from a pre-tax reform year (i.e., prior to January 1, 2018) to a post-tax reform year (i.e., after January 1, 2018).

Base erosion tax benefits

Under the BEAT statute, base erosion tax benefits generally refer to the deductions allowed for the taxable year with respect to base erosion payments. They generally include (i) deductions allowed from deductible payments to foreign corporations, (ii) deductions allowed for depreciation and amortization resulting from the acquisition of property from a related foreign corporation, (iii) reductions in gross amounts of premiums attributable to certain reinsurance payments, and (iii) reductions in gross receipts attributable to payments to surrogate foreign corporations. The amount of base erosion tax benefits is used to determine both the base erosion percentage (discussed above) and modified taxable income (discussed below). The proposed rules provide two clarifications for taxpayers computing their base erosion tax benefits.

First, consistent with the ECI exception and the statute, the proposed rules reduce the amount of the base erosion tax benefit associated with deductible payments made to a foreign related party to zero when full U.S. withholding tax is imposed on such payment. In the event the U.S. withholding tax is reduced under an applicable treaty, the amount of the base erosion tax benefit is similarly reduced (but not to zero) to the extent of the withholding taxes paid.

KPMG observation: The BEAT statute explicitly provided such proportionate treatment for base erosion payments subject to U.S. withholding tax for purposes of determining modified taxable income, but not for purposes of determining the base erosion percentage. The proposed rules would provide consistent treatment of payments subject to withholding tax for both purposes.

Second, the proposed rules would clarify the treatment of interest payments when section 163(j) applies. For purposes of computing a taxpayer's base erosion tax benefits, the statute prescribes a taxpayer unfavorable stacking rule that treats the interest that is limited under section 163(j) as attributable first to any interest paid to unrelated parties, with the result that an increased portion of the interest that is allowed is treated as paid to related parties and potentially subject to the BEAT. Notably, there was an ambiguity left by the statute regarding how the allowed interest should be allocated between foreign related parties and domestic related parties. The proposed rules would clarify this ambiguity by providing for an allocation between foreign related parties and domestic related parties in proportion to the interest actually paid to each. The proposed rules also would provide guidance on the treatment of the excess interest carried over into future years.

Modified taxable income

The basics

The BEAT imposes an additional tax on an Applicable Taxpayer equal to the base erosion minimum tax amount ("BEMTA"). An Applicable Taxpayer's BEMTA is the excess of the applicable percentage of its modified taxable income ("MTI") over its regular tax liability, with certain adjustments. The statute defines MTI as taxable income computed for the taxable year under Chapter 1 "determined without regard to" any (i) base erosion tax benefits and (ii) the base erosion percentage of any NOL deduction allowed under section 172 for the taxable year.

The proposed rule interprets the statutory phrase "without regard to" as simply requiring the identified amounts to be added back to taxable income. This simple add-back approach begins with taxable income as computed for regular tax purposes as the starting point, which means that taxable income might be less than zero if current year deductions exceed gross income (but see the discussion below regarding the special rule for pre-

2018 NOL carryforwards). Taxable income as so computed is then adjusted by adding back the gross base erosion tax benefits and the base erosion percentage of the NOL deduction allowed under section 172. Thus, under the proposed rule the MTI formula is:

- MTI = taxable income + base erosion tax benefits + (base erosion percentage x NOLs).

Unlike the Applicable Taxpayer and Base Erosion Percentage determinations, an Applicable Taxpayer's MTI and BEMTA amounts are determined on a taxpayer-by-taxpayer basis, rather than on the basis of the aggregate group. The proposed rules clarify that domestic corporations that join in filing a U.S. consolidated return are treated as a single taxpayer.

Adoption of the add-back approach and rejection of a more dynamic recomputation approach

The proposed rules adopt an "add-back" approach for computing MTI, rather than the recomputation approach that appears to be a more literal construction of the statutory language ("determined without regard to"). In contrast to the simplified "add-back" approach, a full redetermination of taxable income without regard to the disallowed deductions would also take into account the indirect effects of disallowing those deductions (such as an increased section 163(j) limitation or increased capacity to absorb an NOL carryover). In rejecting this approach, Treasury and the IRS explained that the recomputation approach would create significant complexity that would require separate BEAT-specific attributes to be determined and tracked in a manner similar to attributes under the alternative minimum tax (AMT) regime that was repealed as part of the Act. Thus, it appears to be the view of Treasury and the IRS that the omission of this architecture from section 59A suggests that Congress did not intend for the BEAT to create a separate tax base akin to AMT but, rather, intended to rely instead on the general Code definition of taxable income with limited "static" addbacks for the disallowed amounts.

KPMG observation: Both an add-back approach and various iterations of a recomputation approach seem to be reasonable interpretations of the statutory language. Treasury and the IRS's decision to use the "add-back" approach for computing MTI is consistent with the approach they took in the proposed rules under section 163(j) for computing adjusted taxable income ("ATI"). The relevant statutory language in sections 59A and 163(j) use the same "without regard to" formulation for making the applicable computations, which is also not dissimilar from the pre-Act definition of alternative minimum taxable income under the AMT ("taxable income . . . determined with the adjustments. . . ."), which allowed for a recomputation of taxable income.

The adoption of the add-back approach provides the virtue of simplicity but may result in more BEAT liability in certain situations. In particular, taxpayers with significant attributes that are limited by their taxable income, such as NOLs and interest expense deductions, would seem to be adversely affected by the proposed adoption of the "add-back" approach. Although the proposed rules decline to incorporate the recomputation approach, the preamble explicitly invites comments on the practical effects of an alternative recomputation-based approach, which suggests that it remains possible that final regulations could be drafted to allow taxpayers to apply a recomputation-based alternative to derive MTI.

Treatment of net operating losses

The proposed rules would clarify the effect of NOLs in computing MTI. First, the proposed rules provide that an excess amount of NOL deduction cannot reduce taxable income below zero for determining the starting point for computing MTI. That is, a deduction for a pre-2018 NOL (which is not subject to the new limitation of 80% of taxable income) would be taken into account for purposes of the MTI starting point only to the extent of the amount of taxable income prior to the NOL deduction, with the result that an NOL carryover cannot cause MTI to become negative. Similarly, to compute the add-back for the NOL, the base erosion percentage of the NOL would be applied to the same amount that was used to reduce taxable income in computing the MTI starting point. Accordingly, the add-back would be determined by taking into account the 80% of taxable income limitation for post-2017 NOLs under new section 172(a) and the "no negatives" limitation described above.

The proposed rules include an example illustrating this point (section 1.59A-4(c), Example 1). In Example 1, a domestic corporation ("*DC*") during its 2020 tax year 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 $400x NOL carryforward that arose in 2016. The analysis states that DC's starting point for computing MTI is ($50x), which is the excess of DC's current year deductions over DC's current year gross income. Because DC's taxable income without regard to its pre-2018 NOL carryforwards does not exceed $0x, DC does not take into account any of its pre-2018 NOL carryforward for purposes of computing its MTI or the addback for NOL deductions. DC's add-back amount therefore consists of the $70x base erosion tax benefit and the $0x NOL. Accordingly, DC's MTI for 2020 is $20x, which is computed as (i) ($50x) (DC's regular taxable income) plus (ii) $70x (DC's base erosion tax benefit) and (iii) $0x NOL.

Second, the proposed rules provide that the base erosion percentage of an NOL is the base erosion percentage of the Applicable Taxpayer in the year in which the loss arose (defined in the preamble as the "*vintage year*"), rather than the base erosion percentage of the year in which the NOL is applied to reduce taxable income. If the Applicable Taxpayer is a part of an aggregate group, the base erosion percentage is the aggregate group's base erosion percentage for the year in which the NOL arose, even though the Applicable Taxpayer's NOL is not determined by reference to the aggregate group. Consistent with the vintage year approach, the base erosion percentage for NOLs that arose in tax years beginning before January 1, 2018 is 0, because the BEAT does not apply to tax years beginning before January 1, 2018. The preamble explains that the "vintage year" approach is the preferred method because it provides greater certainty as to the portion of an NOL that will have to be added back, since the percentage used to determine the NOL add-back would be fixed in the year the NOL arose.

The proposed rules include an example illustrating the vintage year-approach (section 1.59A-4(c), Example 2). In Example 2, the facts are the same as in Example 1, except that DC's gross income in 2020 is $500x. The analysis states that DC's MTI starting point is $0x, which is equal to (i) DC's $500x gross income less the sum of (ii)(a) $150x current year deductions and (b) $350x allowable NOL deduction. Because the NOL used in 2020 arose in DC's tax year beginning prior to January 1, 2018, the applicable base erosion percentage is 0. DC's add-back amount is $70x (the base erosion tax benefit amount) plus $0x (the base erosion percentage of the NOL). Accordingly, DC's MTI for 2020 is $70x, which is computed as (i) $0x (DC's regular taxable income) plus (ii) $70x (DC's base erosion tax benefit) plus (iii) $0x (DC's base erosion percentage NOLs).

KPMG observation: Treasury and the IRS's decision to exclude pre-2018 NOLs as an add-back item for purposes of computing MTI is a taxpayer favorable resolution to a vexing BEAT transition issue. This approach also is consistent with Treasury's unexpected decision in the BEAT proposed rules to exclude pre-2018 section 163(j) interest expense carryforwards from the definition of base erosion payments. The tax benefit from excluding pre-2018 NOLs as an add-back item, however, may be at least partially offset for some taxpayers by the floor that prevents NOLs from reducing the MTI starting point below 0.

KPMG observation: The vintage year approach to computing the base erosion percentage of an NOL will require taxpayers to track separately the base erosion percentage of NOLs based on the year in which the NOLs arose. Applicable Taxpayers that are part of an aggregate group will have to track the base erosion percentages by reference to the aggregate group.

KPMG observation: None of the examples in the BEAT proposed rules consider the application of the vintage year method to post-2017 NOLs. To illustrate this scenario, assume the same facts as in Example 2, except that the NOLs arose in 2019. Assume also that DC's 2019 base erosion percentage is the same as the percentage in 2020, 46.7% (.467 = 70x/150x). Under these facts, DC's MTI starting point is $70x because its allowable NOL deduction is limited to 80% of taxable income (350 X .80 = 280). Thus, DC's taxable income is $70x (350 – 280 = 70). DC's add-back amount consists of the $70x of base erosion tax benefit and $130.76x, which is the base erosion percentage of its allowable $280x NOL (280 X .467 = 130.76). Accordingly, DC's MTI for 2020 is $270.76x, which is computed as (i) $70x (DC's regular taxable income) plus (ii) $70x (DC's base erosion tax benefit) plus (iii) $130.76x (DC's base erosion percentage of its NOL).

Base erosion minimum tax amount

The basics

An Applicable Taxpayer's BEMTA for a particular tax year equals the excess of (1) (i) the applicable tax rate for the taxable year (the "BEAT Rate") x (ii) MTI <u>over</u> (2) the taxpayer's adjusted regular tax liability. An Applicable Taxpayer's adjusted regular tax liability generally is equal to its regular tax liability, reduced by certain credits allowed against regular tax liability (but not below zero). Credits that reduce regular tax liability for these purposes cause an offsetting increase in BEMTA; credits that do not reduce regular tax liability for these purposes do not cause such an increase in BEMTA.

For tax years beginning after December 31, 2017 and beginning before January 1, 2026, the following credits do not reduce regular tax liability for BEMTA purposes: (1) the credit allowed under section 38 for the taxable year that is properly allocable to the research credit; (2) a portion equal to 80% of the lesser of (a) the applicable section 38 credits (the low housing credit under section 42(a), the renewable electricity production credit under section 45(a), the investment credit under section 46, but only to the extent properly allocable to the energy credit under section 48), or (b) the BEMTA (determined without regard to the amounts in (2)(a); and (3) credits under section 33 and 37. Number (2) requires parallel computations.

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

BEAT rate

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

- 5%, for taxable years beginning in calendar year 2018
- 10%, for taxable years beginning in calendar year 2019 through taxable years beginning before January 1, 2026
- 12.5%, for taxable years beginning after calendar year 2025.

For a taxpayer that is a member of an affiliated group that includes a bank or a registered securities dealer, these rates are increased by one percentage point to 6%, 11%, and 13.5%, respectively.

Notably, the proposed rules address the application of the above BEAT Rate schedule to fiscal year taxpayers. Specifically, the proposed rules provide that for taxable years beginning after January 1, 2018, section 15 will apply to any taxpayer using a taxable year other than the calendar year. This appears intended to require fiscal year taxpayers to use a blended rate for their tax years, other than any tax year that includes January 1, 2018, by applying a prorated percentage of the number of days prior to and subsequent to the last day of the calendar year within such taxpayer's tax year. Under this approach, for an 11/30 year-end taxpayer, for example, the BEAT rate would be 9.58%, calculated as follows:

- BEMTA = (i) 5% x 31/365 plus (ii) 10% x 334/365 = 9.58%

Fiscal year taxpayers would remain exempt from the BEAT regime in respect of their tax year beginning before January 1, 2018.

KPMG observation: The intent of this rule appears to be to ensure that while non-calendar year end taxpayers benefit from the delayed onset of the BEAT regime in respect of the tax year ending in 2018, the benefits afforded to fiscal year taxpayers would be reduced for tax years beginning after December 31, 2017 because the proposed rule would effectively impose a blended rate for the BEAT Rate transition years (i.e., the 2018-2019 and 2025-2026 tax years). This approach is difficult to reconcile with the statutory language in section 59A(b)(1)(A), which treats 10% as the default rate, but states that a 5% rate would apply to a taxpayer's MTI for the taxable year "in the case of taxable years beginning in calendar year 2018"). The approach of explicitly carving out taxable years beginning in calendar year 2018 from the otherwise effective tax rate of 10% does not fit well with the mechanics of section 15. Further, it appears that the BEAT rate mechanism is intended to start at a low rate to allow taxpayer's time to adapt to the tax. As a result, it is unclear whether the statute permits section 15 to apply to the BEAT for fiscal tax years beginning in 2018.

Application of BEAT to consolidated groups

In addition to confirming that BEAT itself is computed on a consolidated group basis, the proposed regulations contain intricate rules for the co-ordination of the BEAT rules with the proposed section 163(j) regulations for a consolidated group. In general, to the extent a consolidated group's business interest expense ("BIE") is allowed as a deduction in a taxable year, it is classified first as from BIE paid/accrued to a foreign related party and a domestic related party, on a *pro rata* basis, with any remaining BIE deductions treated as BIE paid/accrued to an unrelated party. Under complex rules, this allocation is done on a consolidated basis, and a member's current year BIE can be classified (and thus treated) as (i) domestic-related current year BIE, (ii) foreign-related current year BIE, or (iii) both, regardless of whether the member actually incurred BIE on debt owed to a domestic or foreign related party. These classification rules apply on a year-by-year basis, and the classification of BIE as foreign related party BIE or domestic related party BIE (or if neither, as unrelated party BIE) effectively persists with the BIE, even if it becomes part of a section 163(j) disallowed BIE carryforward.

When a member departs a group, the member's disallowed BIE carryforwards retain their allocated status (*i.e.*, as having been paid/accrued to a domestic or foreign related party or to an unrelated party). Similarly, if a member's assets are acquired in a section 381(a) transaction (such as a tax-free section 368(a)(1) asset reorganization or section 332 subsidiary liquidation), the member's disallowed BIE carryforwards are inherited and retain their allocated status. This retained status is taken into account in determining an acquiring group's base erosion tax benefit when the disallowed BIE carryovers are absorbed in the acquiring group.

The proposed regulations would also add the consolidated group's liability for the BEAT tax to the list of taxes in section 1.1502-2, which would confirm that each entity that is a member of a consolidated group during any portion of a consolidated return year is severally liable for the group's BEAT tax for that year.

Treatment of reinsurance premiums

The proposed rules follow the statute in confirming that premiums and other consideration paid or accrued by an insurance company to a foreign related person for reinsurance generally would be base erosion payments and base erosion tax benefits notwithstanding that such amounts are adjustments to gross income and therefore do not give rise to deductions under the Code. As a consequence, the regulations would include these amounts in both the numerator and denominator of the base erosion percentage and in gross receipts for purposes of the applicable taxpayer test. The regulations also clarify that return premium paid by an insurance company to a foreign related party is a reduction to gross receipts.

KPMG observation: The preamble to the proposed rules responds to comments made by the insurance industry regarding the calculation of gross income, primarily by requesting additional comments. While the proposed rules specify that taxpayers may not net receipts and payments for purposes of the BEAT in a manner different than allowed under general tax rules (even when the parties have a right of setoff against each other and the amounts are settled on a net basis), the preamble requests that taxpayers comment on whether there should be a distinction between reinsurance contracts with netting and other commercial contracts. This request seems to be referring to modified co-insurance and funds withheld insurance arrangements, but could be meant more broadly. The preamble also acknowledges that for purposes other than section 59A, the Code describes payments of claims for losses incurred made by insurance companies that are not life insurance companies as both reductions of gross receipts and as deductions against gross income. The question of whether a non-life insurance company is free to treat the payments as one or the other for purposes of characterizing the payments as base erosion payments under section 59A has been widely debated. While requesting comments on the appropriate treatment of the claims payments in general, but failing to insist that claims payments be treated as deductions, the proposed rules and preamble can be read as signaling recognition (at least pending future guidance) of the position that payments of claims to related foreign persons are not base erosion payments. The preamble also requests comments on whether life insurance companies should obtain the same treatment of claims payments as non-life insurance companies.

KPMG observation: The preamble confirms that entities making the section 953(d) election would be treated as domestic corporations for purposes of section 59A. Thus, insurance companies that wish to avoid BEAT may consider electing section 953(d) treatment. However, once the 953(d) election is made, the insurance company would no longer be able to enjoy a reduced effective tax rate in a lower-tax jurisdiction (or to enjoy a lower U.S. tax rate under the Global Intangible Low-Taxed Income rules) and any losses in the electing company would be subject to the dual consolidated loss rules. Thus, insurance companies would need to weigh the benefit of avoiding BEAT against the tax consequences of making the election.

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