KPMG report: Highlights of final BEAT regulations under section 59A

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The IRS on September 1, 2020, posted on its website final regulations (T.D. 9910) (the "2020 final regulations") regarding the section 59A base erosion and anti-abuse tax (BEAT), which applies to payments made by certain large corporate taxpayers to foreign related parties. The 2020 final regulations finalize guidance provided in proposed regulations [REG-112607-19] published on December 6, 2019 (the "2019 proposed regulations"). The 2020 final regulations also modify certain guidance provided in final regulations under Section 59A that were published on December 6, 2019 (the "2019 final regulations").

Read the **final regulations** [PDF 335 KB] (103 pages)

The version of the 2020 final regulations released by the IRS includes the following statement:

> This document is in the process of being submitted to the Office of the Federal Register (OFR) for publication and will be pending placement on public display at the OFR and publication in the Federal Register. The version of the proposed rule [sic] released today may vary slightly from the published document if minor editorial changes are made during the OFR review process. The document published in the Federal Register will be the official document.

This report provides KPMG's initial impressions and observations about the 2020 final regulations, as posted on the IRS website on September 1, 2020.

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Applicability dates

The 2020 final regulations generally apply to tax years beginning on or after the date the regulations are published in the Federal Register. The rules in Reg. sections 1.59A-7(c)(5)(v) (regarding partnership allocations of income in lieu of deductions) and 1.59A-9(b)(5) and (6) (regarding partnership anti-abuse rules) apply to tax years ending on or after December 2, 2019. Taxpayers may apply the 2020 final regulations in their entirety for tax years beginning after December 31, 2017, and before their applicability date, provided that, once applied, taxpayers must continue to apply them in their entirety for all subsequent tax years. Alternatively, taxpayers may apply only Reg. section 1.59A-3(c)(5) and (6) (relating to the waiver of deductions) for tax years beginning after December 31, 2017, and before their applicability date, provided that, once applied, taxpayers must continue to apply them in their entirety for all subsequent tax years.

Taxpayers also may to rely on the 2019 proposed regulations in their entirety for tax years beginning after December 31, 2017, and before the final regulations are applicable. If a taxpayer chooses to apply both the 2019 proposed regulations and the 2018 proposed regulations to a tax year ending on or before December 6, 2019, the taxpayer is not required to apply aggregate group rules in Prop. Reg. sections 1.59A-2(c)(2)(ii), (c)(4), (c)(5), and (c)(6) to that tax year.

Determination of a taxpayer's aggregate group

The 2019 final regulations provide generally that a taxpayer that is a member of an aggregate group measures the gross receipts and base erosion percentage of its aggregate group for a tax year by including its own gross receipts, base erosion tax benefits, and deductions, as well as those of each member of the aggregate group that ends with or within the taxpayer's tax year (the "with-or-within rule"). The 2019 proposed regulations proposed special rules to calculate gross receipts and base erosion percentage of taxpayers and aggregate groups in specific situations, including rules relating to short tax years, members joining or leaving a taxpayer's aggregate group, and predecessor entities. The final regulations finalize most of these special rules, with modifications.

Determining gross receipts and base erosion percentage of aggregate group for short tax years

In the case of a taxpayer with a short tax year, the 2019 proposed regulations provided that to determine the gross receipts and base erosion percentage of its aggregate group members for that short tax year, the taxpayer must use a reasonable approach that would neither over-count nor under-count the gross receipts, base erosion tax benefits, and deductions of the aggregate group members. In response to a comment, the 2020 final regulations clarify that excluding aggregate group members whose tax years do not end with or within the taxpayer's short year would not be a reasonable method and include additional examples illustrating methods that would and would not be considered reasonable.

The 2020 final regulations also provide rules applying an annualization approach where applying the with-or-within rule would result in including tax years comprised of either more or less than 12 months. A new anti-abuse rule applies where a taxpayer or member of the taxpayer's aggregate group enters into a transaction (or series of transactions), plan, or arrangement with a corporation that is either another member of the aggregate group or a foreign related party, if the transaction has a principal purpose of avoiding applicable taxpayer status by changing the period taken into account under the gross receipts or base erosion tests.

Members leaving and joining an aggregate group

The 2019 proposed regulations provided that a taxpayer determining the gross receipts and base erosion percentage of its aggregate group would take into account only items of members that occurred during the period they were members of the aggregate group. To implement this approach, the 2019 proposed regulations treated a corporation that joined or left an aggregate group as having a deemed tax year-end immediately before the corporation joined or left the aggregate group. The 2020 final regulations retain the general approach of the 2019 proposed regulations, but treat the deemed tax year-end as occurring at the end of the day of the transaction, and provide rules to determine how to allocate items to the deemed tax years before and after the deemed year-end. In general, items are allocated either by deeming a closing of the books at the deemed tax year-end, or, by allocating items (other than extraordinary items) pro-rata. Extraordinary items are generally allocated based on the day on which they are taken into account.

Election to waive allowable deductions

In general

The 2019 proposed regulations provided a mechanism for taxpayers to waive deductions that otherwise would be base erosion tax benefits (the "BEAT waiver election"). Under the 2019 proposed rules, a taxpayer may forgo a deduction that would otherwise create a base erosion tax benefit, provided the taxpayer waives the deduction for all U.S. federal income tax purposes and follows certain specified procedures. The waiver was broad and permitted the waiver of deductions in whole or in part. Thus, a portion of a deduction associated with a particular cost or expense could be waived with the rest of the cost or expense retaining its character and remaining available as a deduction. Under the 2019 proposed regulations, all deductions which could be properly claimed by a taxpayer for the tax year, determined after giving effect to the taxpayer's permissible method of accounting and elections, are treated as "allowed" deductions for the BEAT, other than deductions that the taxpayer explicitly elects to waive using the special election provided in the proposed regulations. The 2020 final regulations retain this waiver election but provide that the election is available only to a taxpayer that could be an applicable taxpayer but for the election.

KPMG observation

The preamble to the final regulations provides an example of this "but for" test involving a controlled foreign corporation ("CFC") that does not have income that is effectively connected with the conduct of a U.S. trade or business ("ECI") and concludes that the CFC may not make a BEAT waiver election because the CFC cannot be an applicable taxpayer. This rule presumably is intended to prevent corporations that are not BEAT taxpayers from using the BEAT waiver election to waive deductions for reasons unrelated to the BEAT. Thus, a domestic corporation that does not meet the base erosion percentage test presumably may not make a BEAT waiver election, even though it might wish to make the BEAT waiver election for other reasons.

Time and manner of making a BEAT waiver election

The 2019 proposed regulations included certain reporting rules in connection with the waiver of deductions and provided guidance on the time and manner for electing to waive deductions. Under the 2019 proposed rules, a taxpayer may elect to waive deductions on its original filed federal income tax return, by an amended return, or during the course of an examination of the taxpayer's income tax return for the relevant tax year pursuant to procedures prescribed by the Commissioner. A taxpayer could increase a BEAT waiver election on an amended return or during the course of an examination, but a taxpayer could not decrease the amount of deductions waived under the BEAT waiver election or revoke an election on an amended return or during an examination. Under the 2019 proposed regulations, a taxpayer made a BEAT waiver election by completing the relevant section of the Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*, and by attaching a list on information specified in the regulations. An election is made separately for each year, and a taxpayer does not need the consent of the Commissioner to choose not to make the election for a subsequent year. The 2020 final regulations retain these rules and procedures but eliminate the requirement that taxpayers provide a "detailed" description of the item or property to which the election relates.

KPMG observation

The preamble to the 2020 final regulations explains that Treasury rejected comments requesting that the final regulations permit taxpayers to decrease the amount of waived deductions—either by filing an amended return or during an examination—because Treasury was concerned that permitting taxpayers to elect to reduce waived amounts would increase uncertainty to the IRS and negatively impact the IRS's ability to efficiently conduct and close examinations.

Treasury also rejected comments recommending that Treasury provide automatic relief for taxpayers that would like to revoke prior elections under section 59(e)(4) (to capitalize certain research and development expenditures) or section 168(k)(7) (to not claim additional bonus depreciation) in light of the BEAT waiver election. Some of the comments indicated that if taxpayers had known about the BEAT waiver election at the time they filed their 2018 tax return they would not have made elections under section 59(e)(4) or 168(k)(7). The preamble explains that Treasury rejected these comments because the recommendations would permit taxpayers to use hindsight to change their elections to reduce or eliminate BEAT liability or regular income tax and the use of hindsight in elections involves tax policy considerations broader than the interaction of the BEAT and the elections under section 59(e)(4) and section 168(k).

Application of the BEAT waiver election to partnerships

The 2020 final regulations include new rules applicable to partners and partnerships. The final regulations allow a corporate partner in a partnership to make a BEAT waiver election with respect to its allocable share of partnership deductions to the extent the corporate partner otherwise qualifies to make a waiver election (i.e., the corporate partner could be an applicable taxpayer in the absence of a BEAT waiver election). If a corporate partner elects to waive a deduction allocated to it by the partnership (or increase the amount of deductions waived) the partner treats the waived amount as a nondeductible expenditure under section 705(a)(2)(B), thereby reducing the partner's adjusted basis in its partnership interest even though deduction did not produce a tax benefit other than reducing the base erosion percentage. The final regulations also provide rules addressing the interaction of a partner's waiver election with section 163(j) and the centralized partnership audit regime.

Partnership transactions

Allocations by a partnership of income instead of deductions

The 2019 proposed regulations contained a proposed rule that would treat income allocations to a contributing partner as deductions in certain situations. Specifically, if a partnership adopts the curative method of making section 704(c) allocations, the allocation of income to the contributing partner in lieu of a deduction allocation to the noncontributing partner would be treated as a deduction for purposes of section 59A in an amount equal to the income allocation. The preamble to the 2019 proposed regulations explains that Treasury is aware that a partner in a partnership can obtain a similar economic result if the partnership allocates income items away from the partner through curative allocations instead of allocating a deduction to the partner. Accordingly, to the extent the partnership allocates less income to a partner due to curative allocations in lieu of allocating a deduction to the partner, the proposed regulations provide that the partner is similarly treated as having a deduction to the extent of that substitute allocation, which may be a base erosion tax benefit. The 2020 final regulations retain this rule along with the example in the 2019 proposed regulations illustrating the application of this rule.

Application of ECI exception to partnership transactions

The 2019 final regulations provide an exception to the definition of base erosion payment for amounts paid to foreign related parties that are subject to U.S. tax as ECI (the "ECI exception"). The 2019 final regulations do not provide specific rules for applying the ECI exception to partnership transactions. Rather, the preambles to the 2019 final regulations and the 2019 proposed regulations stated that Treasury was considering comments recommending that contributions of depreciable or amortizable property by a foreign related party to a partnership (in which an applicable taxpayer is a partner), or distributions of depreciable or amortizable property by a partnership (in which a foreign related party is a partner) to an applicable taxpayer, be excluded from the definition of a base erosion payment to the extent that the foreign related party would receive (or would be expected to receive) allocations of income from that partnership interest that would be taxable to the foreign related party as ECI. The 2020 final regulations generally expand the ECI exception to apply to certain partnership transactions to the extent that the ECI exception would apply to a payment or accrual made directly by a taxpayer to a foreign related party.

Partnership anti-abuse rules

The 2019 proposed regulations included two anti-abuse applicable to partnerships. The first rule relates to derivatives on partnership interests or partnership assets, and provided that a taxpayer is treated as having a direct interest in the partnership interest or asset if the taxpayer acquires a derivative on a partnership interest or asset with a principal purpose of avoiding or reducing a base erosion payment. The 2020 final regulations retain this anti-abuse rule but provide that the anti-abuse rule does not apply when a payment with respect to a derivative on a partnership asset qualifies for the qualified derivative payment exception in Reg. section 1.59A-3(b)(3)(ii) and -6.

The second rule was aimed at preventing a partnership from allocating items of income with a principal purpose of eliminating or reducing the base erosion payments of a taxpayer not acting in a partner capacity on amounts paid to or accrued by a partnership that do not change the economic arrangement of the partners. The preamble to the 2019 proposed regulations illustrates this rule with an example that assumes that a domestic corporation and a third party both pay equal amounts for services to a partnership with a foreign related party partner and an unrelated partner (each having equal interests in the partnership). If the partnership allocates the income it receives from the domestic corporation to the unrelated partner while allocating an equivalent amount of income from the third party to the foreign related party partner with a principal purpose of eliminating the domestic corporation's base erosion payment, the domestic corporation would determine its base erosion payment as if the allocations had not been made and the partners shared the income proportionately. In this case, half of the domestic corporation's payment would be considered a base erosion payment. This anti-abuse rule does not operate if the economic arrangement of the partners is changed by the allocation. The 2020 final regulations retain this anti-abuse rule.

Partnership reporting

The 2019 proposed regulations proposed to amend the regulations under section 6031 to require reporting by certain partners in a foreign partnership when the foreign partnership is not required to file Form 1065. Specifically, if a foreign partnership is not required to file a partnership return and the foreign partnership has made a payment or accrual that is treated as a base erosion payment of a partner, a partner that is required to file Form 8991 (or successor) generally would be required to provide the information necessary to report any base erosion payments on Form 8991 (or successor) under the related instructions. The 2020 final regulations retain this rule.

Anti-abuse rule related to nonrecognition transactions

The 2019 final regulations provided an exception from base erosion payment treatment for amounts transferred to, or exchanged with, a foreign related party in a transaction to which sections 332, 351, 355, or 368 apply (specified nonrecognition transactions). This exception was subject to an anti-abuse rule providing that if a transaction (or series of transactions), plan, or arrangement had a principal purpose of increasing the adjusted basis of property that a taxpayer acquired in a specified nonrecognition transaction, the specified nonrecognition transaction would not qualify for an exception from being a base erosion payment. Such a principal purpose was deemed to exist for a transaction (or series of transactions), plan, or arrangement between related parties that increased the adjusted basis of property within six months prior to the specified nonrecognition transaction.

The 2020 final regulations leave the approach of the 2019 final regulations in place, but clarify that the anti-abuse rule will not apply to a transaction, plan or arrangement that results in an increased basis (a "basis step-up transaction") unless the basis step-up transaction had as a principal purpose increasing depreciation or amortization deductions without increasing base erosion tax benefits. In addition, the 2020 final regulations provide that where the anti-abuse rule applies, only the increase in basis due to the step-up transaction is disqualified from the exception to base erosion payment status.

KPMG observation

The final regulations provide helpful changes that limit the potential scope of the anti-abuse rule. Some taxpayers were concerned that the rule in the 2019 final regulations created a "cliff effect" whereby any amount of pre-transaction basis step-up could disqualify an entire transaction from qualifying for the specified nonrecognition transaction exception, even if the basis step-up was relatively small. The final regulations resolve this issue by providing that only the increase in basis is disqualified from the exception.

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