UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 19, 2019

Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20044

**RE: IRS REG-104259-18 - Guidance Related to Section 59A (Base Erosion and Anti-Abuse Tax)**

Dear Commissioner Rettig:

USCIB[1] is pleased to provide comments on the proposed regulations regarding guidance related to the Base Erosion and Anti-Abuse Tax ("BEAT") under section 59A (REG-104259-18).

The comment period for these regulations is very compressed, especially given the number of other regulations that need to be evaluated and that these regulations interact with each other. Companies will only discover problems as they work with the regulations and apply them to their facts. If the regulations are finalized before problems can be identified, then correcting problems will be more difficult. USCIB is aware that the government would like to meet the 18-month deadline imposed by section 7805(b)(2). Nevertheless, there should be a mechanism to review these regulations (and other TCJA guidance) to correct for unexpected interactions that create distortive results. One option would be to issue the regulations as temporary regulations with a cross-referenced notice of proposed rulemaking. This approach would both permit the regulations to be retroactive under 7805(b)(2) and allow additional comments to be considered as the regulations move from temporary to final.

The Treasury and the IRS should also make every effort to incorporate clerical changes into the final regulations. To the extent that there is pressure to finalize these regulations in the short-term and there are obvious glitches in the statutory language that need to be addressed, finalizing regulations that perpetuate those mistakes will complicate compliance for both taxpayers and the government going forward.

In determining whether they have regulatory authority to adopt the changes suggested below, Treasury and the IRS should consider not only regulatory authority granted under section 59A, but also the general authority of section 7805(a) and authority under other sections, such as section 482.

## I. Definition of Base Erosion Payment; Base Erosion Percentage

### A. Services Cost Method Exception

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

USCIB is generally pleased with the approach of Prop. Reg. § 1.59A-3(b)(3)(i) to the services cost method exception, including the proposed modifications to the recordkeeping requirements. USCIB agrees with the analysis in the preamble and recommends that the proposed rule be included in the final regulations.

Payments for services on the "excluded activities" list of Treas. Reg. § 1.482-9(b)(4), such as research and experimentation ("R&E") services, do not qualify for services cost method under that rule and, accordingly, would not qualify for the services cost method exception in Section 59A. However, USCIB recommends that the final regulations expand the services cost method exception to payments for the development, enhancement, or maintenance of IP held in the United States, so that the cost element of such a payment would not constitute a base erosion payment.

Such an expansion would be consistent with section 59A's deference to the regulatory definition of services cost method-eligible activities and with the TCJA's objective of encouraging U.S. businesses to hold IP onshore. Because the services exception is limited to the cost element of any service fee, in principle, no U.S. tax base erosion can result from applying the exception to R&E payments. Moreover, if the services cost method exception is limited to payments for R&E services for the development, enhancement, or maintenance of IP owned by the applicable taxpayer or a member of its affiliated group, the exception will apply only to U.S. base-enhancing arrangements. This limited expansion of the services cost method exception would support the policy objectives of the BEAT and of the legislation overall.

USCIB also thinks consideration should be given to applying the SCM without regard to the types of services enumerated in Regs. section 1.482-9(b)(4), which are intended to include "core" business functions. The explicit suspension of the "business judgment rule" in section 59A(d)(5)(A) strongly implies that Congress expected "core" business functions to qualify for exclusion, so long as they satisfy the standards for covered services under Regs. section 1.482-9(b)(3).

B. Amortization of R&E

Effective for taxable years beginning after December 31, 2021, section 174 will require the amortization of R&E expenditures. Once that section is in effect, the BEAT payment associated with R&E expenses should be limited to the amount of amortization, regardless of whether Treasury and the IRS adopt the above suggestion. The final regulations should make this limitation clear.

C. Treatment of Nonrecognition Transactions

USCIB disagrees with the proposed regulations' treatment of inbound nonrecognition transactions. Under section 59A, an "amount paid or accrued" to a foreign related party for the "acquisition" of property constitutes a "base erosion payment." Any amortization or depreciation deduction with respect to such property gives rise to a base erosion tax benefit, which can cause the taxpayer to be subject to the BEAT. The proposed regulations interpret these rules to apply to liquidations, reorganizations, and other nonrecognition transactions. USCIB believes that inbound nonrecognition transactions are generally U.S. tax base-enhancing in that they bring income-producing assets into the U.S. tax system with no corresponding outflow of value. The issuance of domestic corporate stock to a foreign related party does not entail a transfer of value outside the U.S. base, a conclusion implicitly supported by section 317, under which such stock is generally not "property" for purposes of subchapter C of the Code. Moreover, in the context of an inbound liquidation, there is no "amount paid or accrued to a foreign person which is a related person" because the foreign related person never receives anything; both the foreign subsidiary and the stock owned by the domestic corporation are eliminated in the transaction.

Encouraging investment in income-producing property in the U.S. economy was a significant policy objective of the legislation. Although the statute classifies amounts paid or accrued to foreign related parties for such property as base erosion payments, it does not by its terms apply to nonrecognition transactions in which the taxpayer does not record a payment or accrual for federal income tax purposes. Consistent with the terms of the statute and the policy goals of the legislation, USCIB recommends that the final regulations provide that nonrecognition transactions do not give rise to base erosion payments.

If the foregoing, broad recommendation is not implemented, USCIB recommends that the final regulations permit companies to engage in post-acquisition restructuring to transfer IP to the United States following third-party acquisitions, without giving rise to base erosion payments. To the extent the basis of IP transferred into the United States in a nonrecognition transaction is attributable to a third-party acquisition, amortization of such basis should not constitute a base erosion tax benefit. Inbound nonrecognition transactions are often used in post-acquisition restructurings to align a target's legal structure with that of the acquirer, and in other internal restructurings to better align a multinational's legal structure with its commercial operations. Notably, they are often used to bring IP into the United States. The proposed regulations' treatment of nonrecognition transactions provides a significant disincentive to onshoring of IP and other income-producing assets, contrary to the goals of the TCJA.

D. Treatment of Section 988 Losses

USCIB agrees with Treasury and the IRS that section 988 losses do not present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party. Accordingly, USCIB supports Prop. Reg. § 1.59A-3(b)(3)(iv), which excludes from the base erosion payment definition section 988 losses resulting from a payment or accrual to a foreign related party. USCIB likewise supports the exclusion of such losses from the numerator of the BEAT fraction.

In contrast, Prop. Reg. § 1.59A-2(e)(3)(ii)(D), which excludes from the denominator of the BEAT fraction all section 988 losses, is overbroad. USCIB recommends that the final regulations exclude from the denominator of the fraction only those section 988 losses that have been excluded from the numerator.

If the proposed regulation's objective is symmetrical exclusion from the numerator and denominator, consistent with the statutory rules for qualified derivative payments and amounts with respect to services as defined in section 59A(d)(5), the proposed regulation is overbroad to the extent it applies to section 988 losses that do not result from payments or accruals to foreign related parties ("Non-FRP Section 988 Losses"). Such payments do not give rise to base erosion tax benefits and so would never be included in the numerator in the first place.

The rationale for excluding section 988 losses from the numerator because they do not present meaningful base erosion concerns has no direct relevance to the denominator. Section 59A(c)(4)(A)(ii) defines the denominator as including all deductions allowable for the taxable year, except for certain deductions (under sections 172, 245A and 250) that do not represent economic losses incurred in that taxable year. If a deduction represents a real economic loss, the policy underlying section 59A(c)(4)(A)(ii) is to permit the taxpayer to account for this loss in the denominator. Although it is true that Non-FRP Section 988 Losses do not present base erosion concerns, this is because they relate to payments to other U.S. taxpayers and to unrelated parties, not to foreign related parties. If all payments that do not present base erosion concerns were excluded from the denominator, the BEAT fraction would always equal one, a plainly absurd result.

Moreover, for accrual method taxpayers (and mark-to-mark method taxpayers subject to the rule in Prop. Reg. § 1.59A-2(e)(3)(vi)), section 988 losses generally cannot be "timed" or manipulated to artificially inflate the denominator of the BEAT fraction. Thus, if and to the extent that the breadth of Prop. Reg. § 1.59A-2(e)(3)(ii)(D) emanates from concerns about such manipulation, Prop. Reg. § 1.59A-9(b)(2) provides an anti-abuse rule for transactions having a principal purpose of inflating the BEAT denominator.[2]

As defined in section 59A, the denominator of the BEAT fraction generally captures all real economic losses of a U.S. taxpayer, and section 988 losses are indisputably real economic losses. Accordingly, although USCIB agrees that symmetrical treatment of section 988 losses excluded from the numerator is appropriate, the denominator should include Non-FRP Section 988 Losses.

E. Section 301 Transactions

The preamble of the proposed regulations state that there is no base erosion payment in an "in-kind distribution subject to section 301." This language does not appear in the proposed regulations. USCIB recommends that the regulations explicitly provide that no base erosion payment arises in a distribution to which section 301 applies, including a section 302(d) redemption.

F. Interaction with Section 163(j)

USCIB agrees with the conclusion (reversing the approach described in Notice 2018-28) that a payment made prior to January 1, 2018 that is not deductible until after January 1, 2018 because of the limitation under section 163(j) cannot be a base erosion payment and recommends including the proposed rule in the final regulations.

G. Interaction with Sections 871(b) and 882(a)

USCIB supports the decision by the Treasury and the IRS to take into account the U.S. tax treatment of the foreign recipient. It is appropriate to exclude from treatment as base erosion payments amounts that will be included in income by the foreign related payee on a U.S. tax return, either as income effectively connected with the conduct of a U.S. trade or business or profit properly attributable to a permanent establishment, as the case may be.

H. Payments that Give Rise to Subpart F or GILTI Income

Under the proposed regulations, an applicable taxpayer's payment to a CFC is treated as base eroding even if the payment is subject to U.S. taxation under section 951 or 951A. The result is double taxation: the same income is taxed once as subpart F income or GILTI, and then taxed again by the BEAT through denying the deduction to the US shareholder making such payment. Moreover, the income is subject to

[2] If the modification to this anti-abuse rule proposed below were adopted, a section 988 loss incurred in connection with a non-abusive transaction could still be disregarded if a taxpayer were to structure ordinary course transactions to generate offsetting section 988 gains and losses for the principal purpose of inflating the denominator.

a potential third level of tax through the partial or complete elimination of foreign tax credits under section 59A.

In other instances, Treasury has exercised its authority to treat certain payments and deductions as not giving rise to base erosion concerns (e.g., section 988 losses and TLACs). Similarly, a payment that gives rise to a subpart F or GILTI inclusion does not present base erosion concerns because the US shareholder pays tax on its income arising from the payment and the income of the CFCs. All of the income is subject to full US income tax. It is worth noting that Treasury exercised its authority to eliminate double taxation by excluding income inclusions under sections 951 and 951A from the hybrid provisions under sections 245 and 267A.

In the effectively connected income exception, the proposed regulations consider the U.S. tax treatment of the foreign recipient and exclude the income of the foreign party to the extent it is treated as effectively connected income. Like the ECI exception, the US shareholder is taxed on its income from the outbound transaction as well as the tax associated with the foreign entity (in this case, a CFC). These two fact patterns are substantially similar, as in both instances the income from the transactions are reported on US tax returns.

For the above reasons, Treasury should provide that base erosion payments or tax benefits do not include deductible payments that give rise to an inclusion in the gross income of a United States taxpayer under section 951 or 951A.

I. Deductions from Internal Dealings allowed in Computing Business Profits of the PE

Under § 1.59A-3(b)(4)(v)(B) of the proposed regulations, "deductions" from internal dealings allowed in computing business profits of a U.S. permanent establishment ("PE") are treated as base eroding payments to the extent they would be so treated under § 1.59A-3(b)(1). The proposed regulations conflict with the Authorized OECD Approach ("AOA") with respect to internal dealings. Internal dealings are only relevant for the purposes of determining the profit of the permanent establishment and are not otherwise recognized.[3] The United States has been a supporter of the AOA[4] and that approach has been subject to question by other countries, including countries that would like to recognize those dealings for purposes of imposing withholding taxes. Extending the BEAT to internal dealings would lend support to those positions. USCIB, therefore, recommends that the final regulations reverse the decision of the proposed regulations and exclude internal dealings from treatment as a BEAT payment.

## II. De Minimis Exception for Banks and Securities Dealers

USCIB supports the inclusion of a de minimis rule for purposes of applying the lower base erosion percentage threshold to banks and registered securities dealers. We believe, however, that the threshold is set too low. The proposed regulations also provide that "because the base erosion percentage is determined on an aggregate group basis, the lower threshold applies if any member of the aggregate

[3] OECD 2010 Report on the Attribution of Profits to Permanent Establishments, July 22, 2010, Part 1, B-2, section 11, at page 13.

[4] Treasury Department Technical Explanation to the 2006 U.S. Model Tax Treaty, Article 7. Page 23, ".... the use of the Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance." Although the U.S. Treasury has issued a new U.S. Model Income Tax Treaty and Preamble in 2016, the Treasury did not issue a new Model Technical Explanation.

group is a member of an affiliated group that includes a bank or registered securities dealer. The proposed regulations provide a limited exception for members of an affiliated group that includes a bank or registered securities dealer where the bank or registered securities dealer activities are de minimis."[5]

While the de minimis rule is a substantial improvement, it nevertheless creates a significant "cliff" effect. Furthermore, margins relative to gross revenue can differ substantially between financial businesses and other businesses, with financial businesses having much higher gross receipts relative to non-financial businesses. Comparing gross revenues from the banks and securities dealers and other members of the affiliated group may not accurately reflect the relative contributions of those members to the group's profitability. Therefore, USCIB recommends that the final regulations provide for a higher de minimis threshold of 5% and clarify that in characterizing the income of a company with a bank or securities dealer division for purposes of this threshold, the final regulations take into account only gross receipts from the conduct of a banking or securities business.

## III. Application of Section 15

Section 15 provides rules determining the tax rate in the case of rate changes during a taxable year. If the case of a new tax, the tax does not apply until the tax year beginning on or after the effective date of the new tax. In the case of an increase or decrease in an existing tax, section 15 generally applies a blended rate for the period before and after the rate change.

USCIB believes that section 15 cannot apply to the rate increase under section 59A(b)(1)(A) as a matter of statutory interpretation. Congress has expressly provided that the 5% rate shall apply ***in the case of taxable years beginning in calendar year 2018.*** We think this language is clear on its face. Moreover, it is significant that section 15(c) does not contain this effective date language. In contrast, section 59A(b)(2) imposing a 12.5% rate applies "***in the case of any taxable year beginning after December 31, 2025.***" Section 15(c) does include this effective date language. Congress must be presumed to have understood this distinction in drafting section 59A(b). Further, with respect to either "rate increase", we do not believe that section 15 should apply. These are not "tax rates" as understood in the context of section 15, which applies to mid-year changes in "headline" rates. In contrast, the rates specified in section 59A are but one component of a complex formula for calculating the BEAT.

**Anti-abuse rules**

USCIB objects to anti-abuse rules under which abuse is determined under the vague standard of "a principal purpose".[6] USCIB is concerned that any transaction that would result in a lower tax liability could be viewed as satisfying this standard.

For example, Prop. Reg. § 1.59A-9(b)(3) in effect prevents taxpayers from disaffiliating a bank or securities dealers.[7] Disaffiliation will have many other effects, including for non-tax regulatory purposes, and if the

[5] Prop. Reg. preamble page 58.
[6] See Prop. Reg. §1.59A-9(b)(2).
[7] See Prop. Reg. §1.59A-9 (b)(3).

disaffiliation makes sense as a business matter and is permissible under applicable banking and securities rules, Treasury and the IRS should not object to two groups appropriately applying the BEAT rules to those now separate entities. Both groups would remain subject to the BEAT, and there is nothing inherently abusive about two groups separately applying these rules.

Furthermore, in reference to Prop. Reg. § 1.59A-9(b)(2), the government should bear a heavy burden in demonstrating that deductible business expenses or other economic losses are incurred with a principal purpose of increasing the denominator of the base erosion percentage. The proposed regulation appears to render suspect even ordinary course business transactions. In theory, a domestic corporation could structure transactions with unrelated parties to artificially inflate its deductions, with no net effect on its taxable income. It seems unlikely, however, that such manipulation could be achieved with respect to ordinary and necessary business expenses and losses on ordinary course business transactions. Moreover, many non-ordinary course transactions having real economic effects could also fall afoul of the proposed rule. Issuance of debt in the financial markets, for example, could conceivably qualify as abusive.

USCIB recommends that in the final regulations, the anti-abuse rule for denominator-inflating transactions be limited to deductions and losses incurred for <u>the</u> principal purpose of increasing the denominator, and the anti-abuse rule for disaffiliation of banks and registered securities dealers be omitted.

Sincerely,

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