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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-104259-18]

RIN 1545-BO56

Base Erosion and Anti-Abuse Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the tax on base erosion payments of taxpayers with substantial gross receipts and reporting requirements thereunder. The proposed regulations would affect corporations with substantial gross receipts that make payments to foreign related parties. The proposed regulations under section 6038A would affect any reporting corporations within the meaning of section 6038A or 6038C.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-104259-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-104259-18), Courier's desk, Internal Revenue

Service, 1111 Constitution Avenue, NW., Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-104259-18).

FOR FURTHER INFORMATION CONTACT: Concerning §§1.59A-1 through 1.59A-10 of the proposed regulations, Sheila Ramaswamy or Karen Walny at (202) 317-6938; concerning the services cost method exception, L. Ulysses Chatman at (202) 317-6939; concerning §§1.383-1, 1.1502-2, 1.1502-4, 1.1502-43, 1.1502-47, 1.1502-59A, 1.1502-100, and 1.6655-5 of the proposed regulations, Julie Wang at (202) 317-6975 or John P. Stemwedel at (202) 317-5024; concerning §§1.6038A-1, 1.6038A-2, and 1.6038A-4 of the proposed regulations, Brad McCormack or Anand Desai at (202) 317-6939; concerning submissions of comments and requests for a public hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under sections 59A, 383, 1502, 6038A, 6038C, and 6655 of the Internal Revenue Code (the "Code"). The Tax Cuts and Jobs Act, Pub. L. 115-97 (2017) (the "Act"), which was enacted on December 22, 2017, added section 59A to the Code. Section 59A imposes on each applicable taxpayer a tax equal to the base erosion minimum tax amount for the taxable year (the "base erosion and anti-abuse tax" or "BEAT").

The Act also added reporting obligations regarding this tax for 25-percent foreign-owned corporations subject to section 6038A and foreign corporations subject to section 6038C and addressed other issues for which information reporting under those sections is important to tax administration.

Explanation of Provisions

I. Overview

These proposed regulations provide guidance under section 59A regarding the determination of the tax on base erosion payments for certain taxpayers with substantial gross receipts. In general, the proposed regulations provide rules for determining whether a taxpayer is an applicable taxpayer on which the BEAT may be imposed and rules for computing the taxpayer's BEAT liability.

Part II of this Explanation of Provisions section describes the rules in proposed §1.59A-2 for determining whether a taxpayer is an applicable taxpayer on which the BEAT may be imposed. Part III of this Explanation of Provisions section describes the rules in proposed §1.59A-3(b) for determining the amount of base erosion payments. Part IV of this Explanation of Provisions section describes the rules in proposed §1.59A-3(c) for determining base erosion tax benefits arising from base erosion payments. Part V of this Explanation of Provisions section describes the rules in proposed §1.59A-4 for determining the amount of modified taxable income, which is computed in part by reference to a taxpayer's base erosion tax benefits and base erosion percentage of any net operating loss deduction. Part VI of this Explanation of Provisions section describes the rules in proposed §1.59A-5 for computing the base erosion minimum tax amount, which is computed by reference to modified taxable income. Part VII of this Explanation of Provisions section describes general rules in proposed §1.59A-7 for applying the proposed regulations to partnerships. Part VIII of this Explanation of Provisions section describes certain rules in the proposed regulations that are specific to banks and registered securities dealers. Part IX of this Explanation of Provisions section describes certain rules in the proposed regulations that are specific to insurance companies. Part X of this Explanation of Provisions section describes the anti-abuse rules in proposed §1.59A-9.

Parts XI-XIII of this Explanation of Provisions section address rules in proposed §1.1502-59A regarding the general application of the BEAT to consolidated groups. Part XIV of this Explanation of Provisions section addresses proposed amendments to §1.383-1 to address limitations on a loss corporation's items under section 382 and 383 in the context of the BEAT. Part XV of this Explanation of Provisions section describes reporting and record keeping requirements.

II. <u>Applicable Taxpayer</u>

The BEAT applies only to a taxpayer that is an applicable taxpayer. Proposed §1.59A-2 provides rules for determining if a taxpayer is an applicable taxpayer.

Generally, an applicable taxpayer is a corporation (other than (1) a regulated investment company ("RIC"), (2) a real estate investment trust ("REIT"), or (3) an S corporation) that satisfies the gross receipts test and the base erosion percentage test. Section 59A and the proposed regulations provide that the taxpayer and certain other corporations that are related to the taxpayer are treated as one person for purposes of determining whether a taxpayer satisfies these tests.

Part II.A of this Explanation of Provisions section describes the proposed rules for determining the aggregate group for applying the gross receipts test and the base erosion percentage test. Part II.B of this Explanation of Provisions section describes the proposed rules for applying the gross receipts test. Part II.C of this Explanation of Provisions section describes the proposed rules for applying the base erosion percentage test. Part II.D of this Explanation of Provisions section describes the proposed rules for applying these tests on an aggregate group basis when members of the aggregate group have different taxable years. Part II.E of this Explanation of Provisions section describes proposed rules for computing the base erosion percentage for a taxpayer with deductions taken into account under a mark-to-market method of accounting.

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

Section 59A(e)(3) aggregates corporations ("aggregate group") on the basis of persons treated as a single employer under section 52(a), which treats members of the "same controlled group of corporations" (as defined in section 1563(a) with certain modifications) as one person. Although a section 1563(a) controlled group can include both foreign and domestic corporations, the proposed regulations treat foreign corporations as outside of the controlled group for purposes of applying the aggregation rules, except to the extent that the foreign corporation has effectively connected income. This limitation on the extent to which foreign corporations are included in the aggregate group ensures that payments made by a domestic corporation, or a foreign corporation with respect to its effectively connected income, to a foreign related corporation are not inappropriately excluded from the base erosion percentage test. Accordingly, the proposed regulations provide that a taxpayer must apply the gross receipts test and the base erosion percentage test using the aggregate group consisting of members of the same controlled group of corporations for purposes of section 52(a) that are (i) domestic corporations and (ii) foreign corporations, but only with regard to gross receipts taken into account in determining income which is effectively connected with the conduct of a trade or business in the United States and subject to tax under section 882(a). The proposed regulations limit the aggregate group to corporations that benefit from deductions, and accordingly may have base erosion tax benefits, while excluding foreign corporations that are not subject to U.S. income tax (except on a gross basis under section 881, with respect to income that is not effectively connected with a trade or business in the United States) and do not benefit from deductions. In the case of a foreign corporation that determines its net taxable income under an applicable income tax treaty of the United States, the foreign corporation is a member of the aggregate group with regard to gross receipts taken into account in determining its net taxable income.

The proposed regulations generally provide that payments between members of the aggregate group are not included in the gross receipts of the aggregate group, consistent with the single entity concept in section 59A(e)(3). Similarly, the proposed regulations generally provide that payments between members of the aggregate group are also not taken into account for purposes of the numerator or the denominator in the base erosion percentage calculation.

Payments between the aggregate group and any foreign corporation that is not within the aggregate group with respect to the payment are taken into account in applying both the gross receipts test and the base erosion percentage test. However, because a foreign corporation is considered within the aggregate group to the extent it is subject to net income tax in the United States, payments to a foreign corporation from within the aggregate group that are subject to net income tax in the United States are eliminated and not taken into account in applying the gross receipts test and the base erosion percentage test. Thus, it may be the case that a payment by a domestic corporation to a foreign corporation is not taken into account in determining applicable taxpayer status because the payee is subject to net income tax in the United States on that payment, while another payment by the same domestic corporation to the same foreign corporation is taken into account in determining applicable taxpayer status because the payee is not subject to net income tax in the United States on that payment. The Treasury Department and the IRS welcome comments on the proposed regulations addressing the aggregate group for purposes of the gross receipts test and the base erosion percentage test.

B. Gross Receipts Test

A taxpayer satisfies the gross receipts test if the taxpayer, or the aggregate group of which the taxpayer is a member, has $500 million or more of average annual gross receipts during the three prior taxable years. In the case of a foreign corporation, the gross receipts test only takes into account gross receipts that are taken into account in determining income that is subject to net income tax as income effectively connected with the conduct of a trade or business within the United States, or taken into account in determining net taxable income under an applicable U.S. income tax treaty.

In the case of an aggregate group, the proposed regulations measure gross receipts of a taxpayer by reference to the taxpayer's aggregate group determined as of the end of the taxpayer's taxable year for which BEAT liability is being computed, and takes into account gross receipts of those aggregate group members during the three-year period preceding that taxable year.

The proposed regulations further clarify how a taxpayer computes gross receipts, including providing rules for corporations that have been in existence for fewer than three years or have short years. These proposed rules are generally consistent with rules set forth in section 448(c). See section 59A(e)(2)(B) (providing that rules similar to the rules of section 448(c)(3)(B) through (D) apply in determining gross receipts for purposes of section 59A). The proposed regulations also clarify how gross receipts are determined if members of the aggregate group have different taxable years, as discussed in Part II.D of this Explanation of Provisions section.

In addition, the proposed regulations clarify how gross receipts are determined for corporations subject to tax under subchapter L (including a foreign corporation subject to tax under section 842(a)).

If a member of an aggregate group owns an interest in a partnership, the proposed regulations provide that the group includes its share of the gross receipts of the partnership in its gross receipts computation. The aggregate group's share of the gross receipts of the partnership is proportionate to its distributive share of items of gross income from the partnership. See Part VII of this Explanation of Provisions section for a more detailed description of the application of section 59A to partnerships.

C. Base Erosion Percentage Test

The base erosion percentage test is satisfied with respect to a taxpayer if the taxpayer (or if the taxpayer is a member of an aggregate group, the aggregate group of which the taxpayer is a member) has a base erosion percentage of three percent or more. Generally, a lower threshold of two percent applies if the taxpayer, or a member of the taxpayer's aggregate group, is a member of an affiliated group (as defined in section 1504(a)(1)) that includes a domestic bank or registered securities dealer. The proposed regulations provide that the lower two percent threshold does not apply, however, in the case of an aggregate group or consolidated group that has de minimis bank or registered securities dealer activities. See Part VIII of this Explanation of

Provisions section for a more detailed description of these rules.

The proposed regulations provide that the base erosion percentage for a taxable year is computed by dividing (1) the aggregate amount of base erosion tax benefits (the "numerator") by (2) the sum of the aggregate amount of deductions plus certain other base erosion tax benefits (the "denominator"). As described in Part II.A of this Explanation of Provisions section, in the case of a taxpayer that is a member of an aggregate group, the base erosion percentage is measured by reference to the deductions or certain reductions in gross income of the taxpayer and members of the taxpayer's aggregate group as of the end of the taxpayer's taxable year. Base erosion tax benefits are generally the deductions or reductions in gross income that result from base erosion payments. Part III of this Explanation of Provisions section describes the proposed rules for determining the amount of base erosion payments, and Part IV of this Explanation of Provisions section describes the proposed rules for determining the base erosion payments that give rise to base erosion tax benefits.

The numerator of the base erosion percentage excludes deductions for (i) amounts paid or accrued to foreign related parties for services qualifying for the exception in proposed §1.59A-3(b)(3)(i) (the "services cost method ("SCM") exception"), (ii) payments covered by the qualified derivatives payments ("QDP") exception in proposed §1.59A-3(b)(3)(ii), and (iii) amounts excluded pursuant to the total loss-absorbing capacity ("TLAC") exception in proposed §1.59A-3(b)(3)(v). See Parts III.B.1, III.B.2, and III.B.5 of this Explanation of Provisions section, for discussions of the SCM exception, QDP exception, and TLAC exception, respectively. Generally, these deductions are also excluded from the denominator of the base erosion percentage.

An applicable taxpayer may make a payment to a foreign related party that is not a member of the aggregate group, if, for example, the recipient of the payment is a 25-percent owner as described in proposed §1.59A-1(b)(17) who does not own more than 50 percent of the applicable taxpayer, and that payment may qualify for the ECI exception described in proposed §1.59A-3(b)(3)(iii). If so, and if that payment also qualifies for either the SCM exception described in proposed §1.59A-3(b)(3)(i), the QDP exception described in proposed §1.59A-3(b)(3)(ii), or the TLAC exception described in proposed §1.59A-3(b)(3)(v), the payment will be included in the denominator for purposes of the base erosion percentage. For example, if an applicable taxpayer makes a deductible payment to a foreign related person who is a 25-percent owner and that payment is both a QDP and subject to federal income taxation as income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or regulations, that deductible payment is included in the denominator of the base erosion percentage. However, if the applicable taxpayer makes a deductible payment to a foreign related person and that payment is a QDP, but not otherwise subject to federal income taxation, that deductible payment is excluded from the denominator of the base erosion percentage.

The proposed regulations also exclude any section 988 losses from the numerator and the denominator in determining the base erosion percentage. See Part III.B.4 of this Explanation of Provisions section, describing the exception for section 988 losses from the definition of base erosion payments.

The numerator of the base erosion percentage only takes into account base erosion tax benefits, which generally are base erosion payments for which a deduction is allowed under the Code for a taxable year. See Part IV of this Explanation of Provisions section. Similarly, the proposed regulations ensure that the denominator of the base erosion percentage only takes into account deductions allowed under the Code by providing that the denominator of the base erosion percentage does not include deductions that are not allowed in determining taxable income for the taxable year.

Finally, because a deduction allowed under section 965(c) to a United States shareholder of a deferred foreign income corporation is not one of the categories of deductions specifically excluded from the denominator under section 59A(c)(4)(B), that deduction is included in the denominator.

In general, as discussed in more detail in Part IV.A of this Explanation of Provisions section, if tax is imposed by section 871 or 881 and that tax has been deducted and withheld under section 1441 or 1442 on a base erosion payment, the base erosion payment is not treated as a base erosion tax benefit for purposes of calculating a taxpayer's modified taxable income. If an income tax treaty reduces the amount of withholding imposed on the base erosion payment, the base erosion payment is treated as a base erosion tax benefit to the extent of the reduction in withholding under rules similar to those in section 163(j)(5)(B) as in effect before the Act.

The proposed regulations apply the same rule concerning withholding taxes for purposes of the base erosion percentage computation. Accordingly, a base erosion tax benefit is not included in the numerator when the payment was subject to tax under section 871 or 881 and that tax has been deducted and withheld under section 1441 or 1442. In addition, the proposed regulations provide that for any base erosion payment subject to a reduced rate of withholding tax under an income tax treaty, the associated amount of base erosion tax benefits eliminated from the numerator of the base erosion percentage calculation is determined using rules similar to those in section 163(j)(5)(B) as in effect before the Act.

The base erosion percentage also takes into account the two categories of base erosion tax benefits that result from reductions in gross income rather than deductions allowed under the Code (that is, (1) certain premium or other consideration paid to a foreign related party for reinsurance, and (2) amounts paid or accrued by the taxpayer to certain surrogate foreign corporations that result in a reduction in gross receipts to the taxpayer). Section 59A(c)(4)(A)(ii)(II) provides that those base erosion tax benefits that result from reductions in gross income are included in the both the numerator and the denominator in the same amount. Other payments that reduce gross income but that are not base erosion payments are not included in the denominator of the base erosion percentage.

D. Taxpayers in an Aggregate Group with Different Taxable Years

Section 59A determines the status of a corporation as an applicable taxpayer on the basis of the aggregate group rules by taking into account the gross receipts and base erosion payments of each member of the aggregate group. However, each member must compute the aggregate group amount of gross receipts and base erosion payments based on its own taxable year and based on those corporations that are members of the aggregate group at the end of such taxable year. Therefore, members with different taxable years may have different base erosion percentages.

However, each corporation that is an applicable taxpayer computes its modified taxable income and base erosion minimum tax amount on a separate taxpayer basis. In the case of a group of affiliated corporations filing a consolidated tax return, the consolidated group is treated as a single taxpayer for purposes of section 59A, and its modified taxable income and base erosion minimum tax amount are determined on a consolidated group basis.

The proposed regulations provide rules for determining whether the gross receipts test and base erosion percentage test are satisfied with respect to a specific taxpayer when other members of its aggregate group have different taxable years. See proposed §1.59A-2(e)(3)(vii). In general, the proposed regulations provide that each taxpayer determines its gross receipts and base erosion percentage by reference to its own taxable year, taking into account the results of other members of its aggregate group during that taxable year. In other words, for purposes of determining the gross receipts, base erosion tax benefits, and deductions of the aggregate group, the taxpayer must include those amounts that occur during the course of the taxpayer's own taxable year, not another member of the aggregate group's taxable year, if different. The proposed regulations adopt this approach to provide certainty for taxpayers and avoid the complexity of a rule that identifies a single taxable year for an aggregate group for purposes of section 59A that may differ from a particular member of the aggregate group's taxable year. As a result of this rule, two related taxpayers with different taxable years will compute their applicable gross receipts and base erosion percentage by reference to different periods, even though in each case the calculations are done on an aggregate group basis that takes into account other members of the controlled group. Taxpayers may use a reasonable method to determine the gross receipts and base erosion percentage information for the time period of the member of the aggregate group with a different taxable year. For an illustration of this rule, see proposed §1.59A-2(f)(2) (Example 2).

The proposed regulations also provide that when determining the base erosion percentage for a taxpayer that is a member of an aggregate group with other members that have a different taxable year, the effective date in section 14401(e) of the Act, as it applies to the taxpayer making the return, controls whether that taxpayer takes into account transactions of other members of its aggregate group. (Section 14401(e) of the

Act provides that section 59A applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.)

Thus, if one corporation (US1) that has a calendar year is a member of an aggregate group with another corporation (US2) that has a taxable year ending November 30, when US1 computes its base erosion percentage for its calendar year ending December 31, 2018, the base erosion payments made by US2 during the period from January 1, 2018, through December 31, 2018, are taken into account with respect to US1 for its computations even though US2's base erosion payments in its taxable year ending November 30, 2018, are not base erosion payments with respect to US2 because of section 14401(e) of the Act. Correspondingly, US2's taxable year beginning December 1, 2017, and ending November 30, 2018, is not subject to section 59A because US2's base erosion payments occur in a year beginning before January 1, 2018, and base erosion payments made by US1 during the period from December 1, 2017 through November 30, 2018, do not change that result. For a general discussion of the Act's effective date for section 59A, see Part III.C of this Explanation of Provisions section.

E. Mark-to-Market Deductions

As discussed in Part II.C of this Explanation of Provisions section, the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, the aggregate group) must determine the amount of base erosion tax benefits in the numerator and the total amount of certain deductions, including base erosion tax benefits, in the denominator to determine the base erosion percentage for the year. The proposed regulations provide rules for determining the amount of base erosion tax benefits in the case of transactions that are marked to market. These proposed rules also apply for determining the total amount of the deductions that are included in the denominator of the base erosion percentage computation.

Specifically, to ensure that only a single deduction is claimed with respect to each transaction, the proposed regulations combine all income, deduction, gain, or loss on each transaction for the year to determine the amount of the deduction that is used for purposes of the base erosion percentage test. This rule does not modify the net amount allowed as a deduction pursuant to the Code and regulations. This rule is intended to prevent distortions in deductions from being included in the denominator of the base erosion percentage, including as a result of the use of an accounting method that values a position more frequently than annually.

III. Base Erosion Payments

The proposed regulations define a base erosion payment as a payment or accrual by the taxpayer to a foreign related party (as defined in §1.59A-1(b)(12)) that is described in one of four categories: (1) a payment with respect to which a deduction is allowable; (2) a payment made in connection with the acquisition of depreciable or amortizable property; (3) premiums or other consideration paid or accrued for reinsurance that is taken into account under section 803(a)(1)(B) or 832(b)(4)(A); or (4) a payment resulting in a reduction of the gross receipts of the taxpayer that is with respect to certain surrogate foreign corporations or related foreign persons.

A payment or accrual that is not within one of the categories may be a base erosion payment described in one of the other categories. For example, a deductible payment related to reinsurance that does not meet the requirements for the third category of base erosion payments may still be a base erosion payment under the first category because the payment is deductible. Nonetheless, to the extent all or a portion of a payment or accrual is described in more than one of these categories, the amount is only taken into account once as a base erosion payment.

Except as otherwise provided in the proposed regulations, the determination of whether a payment or accrual by the taxpayer to a foreign related party is described in one of these four categories is made under general U.S. federal income tax law. For example, the proposed regulations do not explicitly address whether a royalty payment is classified as deductible under section 162 or as a cost includible in inventory under sections 471 and 263A resulting in a reduction in gross income under section 61.

In general, the treatment of a payment as deductible, or as other than deductible, such as an amount that reduces gross income or is excluded from gross income because it is beneficially owned by another person, generally will have federal income tax consequences that will affect the application of section 59A and will also have consequences for other provisions of the Code. In light of existing tax law dealing with identifying who is the beneficial owner of income, who owns an asset, and the related tax consequences (including under principal-agent principles, reimbursement doctrine, case law conduit principles, assignment of income or other principles of generally applicable tax law), the proposed regulations do not establish any specific rules for purposes of section 59A for determining whether a payment is treated as a deductible payment or, when viewed as part of a series of transactions, should be characterized in a different manner.

Part III.A of this Explanation of Provisions section discusses the operating rules for certain specific types of base erosion payments and Part III.B of this Explanation of Provisions section describes certain exceptions to the definition of base erosion payments.

A. Certain Specific Types of Base Erosion Payments

This Part III.A of this Explanation of Provisions describes proposed operating rules for determining whether there is a payment or accrual that can give rise to a base erosion payment. This part also discusses proposed rules coordinating the definition of base erosion payment with rules that allocate deductions for purposes of determining a foreign corporation's effectively connected income.

1. Payments or Accruals That Consist of Non-Cash Consideration

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

The proposed regulations do not include any specific exceptions for these types of transactions even though (a) the transferor of the assets acquired by the domestic corporation may not recognize gain or loss, (b) the acquiring domestic corporation may take a carryover basis in the depreciable or amortizable assets, and (c) the importation of depreciable or amortizable assets into the United States in these transactions may increase the regular income tax base as compared to the non-importation of those assets. The Treasury Department and the IRS have determined that neither the nonrecognition of gain or loss to the transferor nor the absence of a step-up in basis to the transferee establishes a basis to create a separate exclusion from the definition of a base erosion payment. The statutory definition of this type of base erosion payment that results from 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. That amount of basis is imported regardless of whether the transaction is a recognition transaction or a transaction subject to rules in subchapter C or elsewhere in the Code.

In contrast, for transactions in which a taxpayer that owns stock in a foreign related party receives depreciable property from the foreign related party as an in-kind distribution subject to section 301, there is no base erosion payment because there is no consideration provided by the taxpayer to the foreign related party in exchange for the property. Thus, there is no payment or accrual.

In addition, because section 59A(d)(1) defines the first category of base erosion payment as "any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter," a base erosion payment also includes a payment to a foreign related party resulting in a recognized loss; for example, a loss recognized on the transfer of property to a foreign related party. The Treasury Department and the IRS welcome comments about the treatment of payments or accruals that consist of non-cash consideration. See Part III.B.4 of this Explanation of Provisions section for a specific exception from the base erosion payment definition for exchange loss from a section 988 transaction.

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

Section 59A applies to foreign corporations that have income that is subject to net income taxation as effectively connected with the conduct of a trade or business in the United States, taking into account any applicable income tax treaty of the United States. These proposed regulations generally provide that a foreign corporation that has interest expense allocable under section 882(c) to income that is effectively connected with the conduct of a trade or business within the United States will have a base erosion payment to the extent the interest expense results from a payment or accrual to a foreign related party. The amount of interest that will be treated as a base erosion payment depends on the method used under §1.882-5.

If a foreign corporation uses the method described in §1.882-5(b) through (d), interest on direct allocations and on U.S.-booked liabilities that is paid or accrued to a foreign related party will be a base erosion payment. If U.S.-booked liabilities exceed U.S.-connected liabilities, a foreign corporation computing its interest expense under this method must apply the scaling ratio to all of its interest expense on a pro-rata basis to determine the amount that is a base erosion payment. Interest on excess U.S.-connected liabilities also may be a base erosion payment if the foreign corporation has liabilities with a foreign related party.

If a foreign corporation determines its interest expense under the separate currency pools method described in §1.882-5(e), the amount of interest expense that is a base erosion payment is equal to the sum of (1) the interest expense on direct allocations paid or accrued to a foreign related party and (2) the interest expense in each currency pool multiplied by the ratio of average foreign related party liabilities over average total liabilities for that pool. The base erosion payment exceptions discussed in Part III.B of this Explanation of Provisions section may apply and may lower the amount of interest expense that is a base erosion payment.

The Treasury Department and the IRS recognize that §1.882-5 provides certain simplifying elections for determining the interest deduction of a foreign corporation. In particular, §1.882-5(c) generally provides that the amount of U.S.-connected liabilities equals the total value of U.S. assets multiplied by the taxpayer's worldwide leverage ratio. However, §1.882-5(c)(4) allows a taxpayer to elect to use a fixed ratio instead of its actual worldwide leverage ratio. Similarly, §1.882-5(d)(5)(ii)(A) provides a general rule that the deduction for interest on excess U.S.-connected liabilities is determined by reference to the average rate of interest on U.S.-dollar liabilities that are not U.S.-booked liabilities. However, §1.882-5(d)(5)(ii)(B) allows certain taxpayers to elect to determine the deduction by reference to the 30-day London Interbank Offering Rate. The Treasury Department and the IRS request comments about similar simplifying elections for determining the portion of U.S.-connected liabilities that are paid to a foreign related party.

3. Other Deductions Allowed with Respect to Effectively Connected Income

Like excess interest expense, the proposed regulations provide that the amount of a foreign corporation's other deductions properly allocated and apportioned to effectively connected gross income under §1.882-4 are base erosion payments to the extent that those deductions are paid or accrued to a foreign related party. Section 1.882-4(a)(1) generally provides that a foreign corporation engaged in a trade or business within the United States is allowed the deductions which are properly allocated and apportioned to the foreign corporation's gross income which is effectively connected its conduct of a trade or business within the United States. The proposed regulations follow the approach under §1.882-4. Accordingly, the regulations identify base erosion payments by tracing each item of deduction, and determining whether the deduction arises from a payment to a foreign related party.

If a foreign corporation engaged in a trade or business within the United States acquires property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation) from a foreign related party, the amount paid or accrued by the taxpayer to the foreign related party is a base erosion payment to the extent the property is used, or held for use, in the conduct of a trade or business within the United States.

4. Income Tax Treaties

Certain U.S. income tax treaties provide alternative approaches for the allocation or attribution of business profits of an enterprise of one contracting state to its permanent establishment in the other contracting state on the basis of assets used, risks assumed, and functions performed by the permanent establishment. The use of a treaty-based expense allocation or attribution method does not, in and of itself, create legal obligations between the U.S. permanent establishment and the rest of the enterprise. These proposed regulations recognize that as a result of a treaty-based expense allocation or attribution method, amounts equivalent to deductible payments may be allowed in computing the business profits of an enterprise with respect to transactions between the permanent establishment and the home office or other branches of the foreign corporation ("internal dealings"). The deductions from internal dealings would not be allowed under the Code and regulations, which generally allow deductions only for allocable and apportioned costs incurred by the enterprise as a whole. The proposed regulations require that these deductions from internal dealings allowed in computing the business profits of the permanent establishment be treated in a manner consistent with their treatment under the treaty-based position and be included as base erosion payments.

The proposed regulations include rules to recognize the distinction between the allocations of expenses that are addressed in Parts III.A.2 and 3 of this Explanation of Provisions section, and internal dealings. In the first instance, the allocation and apportionment of expenses of the enterprise to the branch or permanent establishment is not itself a base erosion payment because the allocation represents a division of the expenses of the enterprise, rather than a payment between the branch or permanent establishment and the rest of the enterprise. In the second instance, internal dealings are not mere divisions of enterprise expenses, but rather are priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle. The approach in the proposed regulations creates parity between deductions for actual regarded payments between two separate corporations (which are subject to section 482), and internal dealings (which are generally priced in a manner consistent with the applicable treaty and, if applicable, the OECD Transfer Pricing Guidelines). The rules in the proposed regulations applicable to foreign corporations using this approach apply only to deductions attributable to internal dealings, and not to payments to entities outside of the enterprise, which are subject to the general base erosion payment rules as provided in proposed §1.59A-3(b)(4)(v)(A).

5. Certain Payments to Domestic Passthrough Entities with Foreign Owners or to Another Aggregate Group Member

The proposed regulations also provide rules for certain payments to a domestic trust, REIT or RIC, and for certain payments to a related domestic corporation that is not part of a consolidated group. Proposed §1.59A-3(b)(2)(v) provides a rule that applies when a domestic trust, REIT or RIC receives a payment that otherwise would be a base erosion payment. Proposed §1.59A-3(b)(2)(vi) applies when a taxpayer transfers certain property to a member of an aggregate group that includes the taxpayer, to ensure that any deduction for depreciation (or amortization in lieu of deprecation) by the transferee taxpayer remains a base erosion tax benefit to the same extent as the amount that would have been a base erosion tax benefit in the hands of the transferor.

B. Exceptions from the Base Erosion Payment Definition

1. Exception for Certain Amounts with Respect to Services

The SCM exception described in section 59A(d)(5) provides that section 59A(d)(1) (which sets forth the general definition of a base erosion payment) does not apply to any amount paid or accrued by a taxpayer for services if (A) the services are eligible for the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and (B) the amount constitutes the total services cost with no markup component. The Treasury Department and the IRS interpret "services cost method" to refer to the services cost method described in §1.482-9(b), interpret the requirement regarding "fundamental risks of business success or failure" to refer to the test in §1.482-9(b)(5) commonly called the business judgment rule, and interpret "total services cost" to refer to the definition of "total services costs" in §1.482-9(j).

Section 59A(d)(5) is ambiguous as to whether the SCM exception applies when an amount paid or accrued for services exceeds the total services cost, but the payment otherwise meets the other requirements for the SCM exception set forth in section 59A(d)(5). Under one interpretation of section 59A(d)(5), the SCM exception does not apply to any portion of a payment that includes any mark-up component. Under another interpretation of section 59A(d)(5), the SCM exception is available if there is a markup, but only to the extent of the total services costs. Under the former interpretation, any amount of markup would disqualify a payment, in some cases resulting in dramatically different tax effects based on a small difference in charged costs. In addition, if any markup were required, for example because of a foreign tax law or non-tax reason, a payment would not qualify for the SCM exception. Under the latter approach, the services cost would continue to qualify for the SCM exception provided the other requirements of the SCM exception are met. The latter approach to the SCM exception is more expansive because it does not limit qualification to payments made exactly at cost.

The proposed regulations provide that the SCM exception is available if there is a markup (and if other requirements are satisfied), but that the portion of any payment that exceeds the total cost of services is not eligible for the SCM exception and is a base erosion payment. The Treasury Department and the IRS have determined that this interpretation is more consistent with the text of section 59A(d)(5). Rather than require an all-or-nothing approach to service payments, section 59A(d)(5) provides an exception for "any amount" that meets the specified test. This language suggests that a service payment may be disaggregated into its component amounts, just as the general definition of base erosion payment applies to the deductible amount of a foreign related party payment even if the entire payment is not deductible. See section 59A(d)(1). The most logical interpretation is that a payment for a service that satisfies subparagraph (A) is excepted up to the qualifying amount under subparagraph (B), but amounts that do not qualify (i.e., the markup component) are not excepted. This interpretation is reinforced by the fact that section 59A(d)(5)(A) makes the SCM exception available to taxpayers that cannot apply the services cost method described in §1.482-9(b) (which permits pricing a services transaction at cost for section 482 purposes) because the taxpayer cannot satisfy the business judgment rule in §1.482-9(b)(5). Because a taxpayer in that situation cannot ordinarily charge cost, without a mark-up, for transfer pricing purposes, failing to adopt this approach would render the parenthetical reference in section 59A(d)(5)(A) a nullity. The interpretation the proposed regulations adopt gives effect to the reference to the business judgment rule in section 59A(d)(5). The Treasury Department and the IRS welcome comments on whether the regulations should instead adopt the interpretation of section 59A(d)(5) whereby the SCM exception is unavailable to a payment that includes any mark-up component.

To be eligible for the SCM exception, the proposed regulations require that all of the requirements of §1.482-9(b) must be satisfied, except as modified by the proposed regulations. Therefore, a taxpayer's determination that a service qualifies for the SCM exception is subject to review under the requirements of §1.482-9(b)(3) and (b)(4), and its determination of the amount of total services cost and allocation and apportionment of costs to a particular service is subject to review under the rules of §1.482-9(j) and §1.482-9(k), respectively.

Although the proposed regulations do not require a taxpayer to maintain separate accounts to bifurcate the cost and markup components of its services charges to qualify for the SCM exception, the proposed regulations do require that taxpayers maintain books and records adequate to permit verification of, among other things, the amount paid for services, the total services cost incurred by the renderer, and the allocation and apportionment of costs to services in accordance with §1.482-9(k). Because payments for certain services that are not eligible for the SCM due to the business judgment rule or for which taxpayers select another transfer pricing method may still be eligible for the SCM exception to the extent of total services cost, the record-keeping requirements in the proposed regulations differ from the requirements in §1.482-9(b)(6). See §1.59A-3(b)(3)(i)(B)(2). Unlike §1.482-9(b)(6), the proposed regulations do not require that taxpayers "include a statement evidencing [their] intention to apply the services cost method to evaluate the arm's length charge for such services," but the proposed regulations do require that taxpayers include a calculation of the amount of profit mark-up (if any) paid for the services. For purposes of qualifying for the SCM exception under section 59A(d)(5), taxpayers are required to comply with the books and records requirements under these proposed regulations but not §1.482-9(b)(6).

The proposed regulations also clarify that the parenthetical reference in section 59A(d)(5) to the business judgment rule prerequisite for applicability of the services cost method -- "(determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)" -- disregards the entire requirement set forth in §1.482-9(b)(5) solely for purposes of section 59A(d)(5).

2. Qualified Derivative Payments

Section 59A(h) provides that a qualified derivative payment (QDP) is not a base erosion payment. Proposed §1.59A-6 defines a QDP as any payment made by a taxpayer to a foreign related party pursuant to a derivative for which the taxpayer recognizes gain or loss on the derivative on a mark-to-market basis (treats the derivative as sold on the last business day of the taxable year), the gain or loss is ordinary, and any gain, loss, income or deduction on a payment made pursuant to the derivative is also treated as ordinary.

The QDP exception applies only if the taxpayer satisfies reporting requirements in proposed §1.6038A-2(b)(7)(ix). If a taxpayer satisfies the reporting requirements for some QDPs, but not all, then only the payments for which the taxpayer fails to satisfy the reporting requirements will be ineligible for the QDP exception. Section 1.6038A-2(b)(7)(ix) will first apply to taxable years beginning after final regulations are published, which provides taxpayers additional time to meet those reporting requirements. The proposed regulations provide that before final regulations are published, taxpayers satisfy the reporting requirements for QDPs by reporting the aggregate amount of QDPs for the taxable year on Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*.

Section 59A(h)(3) provides two exceptions to the QDP exception. Specifically, the QDP exception does not apply (1) to a payment that would be treated as a base erosion payment if it were not made pursuant to a derivative or (2) with respect to a contract that has derivative and nonderivative components, to a payment that is properly allocable to the nonderivative component. The proposed regulations do not specifically address or modify these statutory provisions. For the avoidance of doubt, the Treasury Department and the IRS observe that these rules in section 59A(h)(3) are self-executing; thus, taxpayers must apply these two rules to determine whether any of their payments pursuant to derivatives fail to qualify for the QDP exception. The Treasury Department and the IRS request comments on whether regulations should further clarify the statutory provisions in section 59A(h)(3).

Proposed §1.59A-6(d) defines a derivative as any contract, the value of which, or any payment with respect to which, is determined by reference to any stock, evidence of indebtedness, actively traded commodity, currency, or any rate, price, amount, index, formula or algorithm. However, direct ownership of any of these items is not ownership of a derivative. The proposed regulations clarify that for purposes of section 59A(h)(4), a derivative does not include an insurance contract, a securities lending transaction, a sale-repurchase transaction, or any substantially similar transaction.

For federal tax purposes, a sale-repurchase transaction satisfying certain conditions is treated as a secured loan. Sections 59A(h)(3) and 59A(h)(4) explicitly exclude from qualified derivatives payment status any payment that would be treated as a base erosion payment if it were not made pursuant to a derivative, such as a payment of interest on a debt instrument. Accordingly, for purposes of section 59A(h), the proposed regulations provide that sale-repurchase transactions are not treated as derivatives. Because sale-repurchase transactions and securities lending transactions are economically similar to each other, the Treasury Department and the IRS have determined that these transactions should be treated similarly for purposes of section

59A(h)(4), and therefore payments on those transactions are not treated as QDPs. The Treasury Department and the IRS request comments on whether securities lending transactions and sale-repurchase transactions have been properly excluded from the definition of a derivative, including whether certain transactions lack a significant financing component such that those transactions should be treated as derivatives for purposes of section 59A(h). The Treasury Department and the IRS also request comments regarding whether any additional transactions or financial instruments should be explicitly excluded from the definition of a derivative.

3. Exception to Base Erosion Payment Status for Payments the Recipient of which is Subject to U.S. Tax

In general, for a payment or accrual to be treated as a base erosion payment, the recipient must be a foreign person (within the meaning of section 6038A(c)(3)) that is a related party with respect to the taxpayer, and a deduction must be allowable with respect to the payment or accrual. See section 59A(f). Section 6038A(c)(3) defines "foreign person" as any person that is not a United States person within the meaning of section 7701(a)(30), but for this purpose the term "United States person" does not include any individual who is a citizen of any U.S. territory (but not otherwise a citizen of the United States) and who is not a resident of the United States. See proposed §1.59A-1(b)(10). The Treasury Department and the IRS have determined that it is appropriate in defining a base erosion payment to consider the U.S. tax treatment of the foreign recipient. In particular, the Treasury Department and the IRS have determined that a payment to a foreign person should not be taxed as a base erosion payment to the extent that payments to the foreign related party are effectively connected income. Those amounts are subject to tax under sections 871(b) and 882(a) on a net basis in substantially the same manner as amounts paid to a United States citizen or resident or a domestic corporation. Accordingly, the proposed regulations include an exception from the definition of base erosion payment for amounts that are subject to tax as income effectively connected with the conduct of a U.S. trade or business. In the case of a foreign recipient that determines its net taxable income under an applicable income tax treaty, the exception from the definition of base erosion payment applies to payments taken into account in determining net taxable income under the treaty.

4. Exchange Loss from a Section 988 Transaction

Proposed §1.59A-3(b)(3)(iv) provides that exchange losses from section 988 transactions described in §1.988-1(a)(1) are not base erosion payments. The Treasury Department and the IRS have determined that these 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, under these proposed regulations, section 988 losses are excluded from the numerator.

The proposed regulations also provide that section 988 losses are excluded from the denominator of the base erosion percentage. Specifically, proposed §1.59A-2(e)(3)(ii)(D) provides that an exchange loss from a section 988 transaction (including with respect to persons other than foreign related parties) is not included in the denominator when calculating the base erosion percentage. Exchange gain from a section 988 transaction, however, is included as a gross receipt for purposes of the gross receipts test under proposed §1.59A-2(d).

The Treasury Department and the IRS request comments on the treatment of section 988 losses in the context of section 59A, including whether the rule relating to section 988 losses in the denominator of the base erosion percentage calculation should be limited to transactions with a foreign related party.

5. Exception for Interest on Certain Instruments Issued by Globally Systemically Important Banking Organizations.

The Federal Reserve requires that certain global systemically important banking organizations (GSIBs) issue TLAC securities as part of a global framework for bank capital that has sought to minimize the risk of insolvency. In particular, the Board of Governors of the Federal Reserve (the Board) has issued regulations that prescribe the amount and form of external TLAC securities that domestic GSIBs must issue and internal TLAC securities that certain foreign GSIBs must issue. In the case of internal TLAC securities, the Board regulations require the domestic intermediate holding company of a foreign GSIB to issue a specified minimum amount of TLAC to its foreign parent. Section 59A(i) provides that the Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 59A, including regulations addressing specifically enumerated situations. The Treasury Department and the IRS have determined that because of the special status of

TLAC as part of a global system to address bank solvency and the precise limits that Board regulations place on the terms of TLAC securities and structure of intragroup TLAC funding, it is necessary and appropriate to include an exception to base erosion payment status for interest paid or accrued on TLAC securities required by the Federal Reserve.

Specifically, the proposed regulations include a TLAC exception that applies only to the extent of the amount of TLAC securities required by the Federal Reserve under subpart P of 12 CFR part 252. As a result, the exception is scaled back if the adjusted issue price of the average amount of TLAC securities issued and outstanding exceeds the average amount of TLAC long-term debt required by the Federal Reserve for the taxable year. The TLAC exception applies only to securities required by the Federal Reserve, and as a result generally does not apply to securities issued by a foreign corporation engaged in a U.S. trade or business because the applicable Federal Reserve requirement applies only to domestic institutions. However, the Treasury Department and the IRS acknowledge that foreign regulators may impose similar requirements on the financial institutions they regulate. The Treasury Department and the IRS request comments regarding a similar exception for foreign corporations that are required by law to issue a similar type of loss-absorbing instrument, including the appropriate scope of an exception that would provide parity between the treatment of domestic corporations and foreign corporations engaged in a U.S. trade or business.

C. Base Erosion Payments Occurring Before the Effective Date and Pre-2018 Disallowed Business Interest

Section 14401(e) of the Act provides that section 59A applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. The statutory definition of a base erosion tax benefit is based upon the definition of a base erosion payment. Accordingly, the proposed regulations confirm the exclusion of a deduction described in section 59A(c)(2)(A)(i) (deduction allowed under Chapter 1 for the taxable year with respect to any base erosion payment) or section 59A(c)(2)(A)(ii) (deduction allowed under Chapter 1 for the taxable year for depreciation or amortization with respect to any property acquired with such payment) that is allowed in a taxable year beginning after December 31, 2017, if it relates to a base erosion payment that occurred in a taxable year beginning before January 1, 2018.

For example, if in 2015, a calendar year taxpayer makes a payment or accrual to a foreign related party to acquire depreciable property, the 2015 payment is excluded from the definition of a base erosion payment because of section 14401(e) of the Act. As a result, the taxpayer's depreciation deduction allowed in 2018 with respect to this property is not a base erosion tax benefit.

Similarly, if in 2016, a taxpayer with a calendar year had paid or accrued interest on an obligation to a foreign related party, but the interest was not deductible in 2016 due to the application of section 267(a), the 2016 accrual of the interest amount is excluded from the definition of a base erosion payment because of section 14401(e) of the Act. As a result, if the interest amount becomes deductible in 2018, the taxpayer's deduction allowed in 2018 with respect to this item is not a base erosion tax benefit.

In the case of business interest expense that is not allowed as a deduction under section 163(j)(1), the proposed regulations provide a rule that clarifies that the effective date rules apply in a similar manner as with other base erosion payments that initially arose before the effective date in section 14401(e) of the Act. Section 163(j), as modified by the Act, provides that the deduction for business interest expense is limited to the sum of business interest income, 30 percent of adjusted taxable income ("ATI"), and the amount of any floor plan financing interest. Section 163(j)(2) further provides that any disallowed business interest is carried forward to the succeeding year, and that the carryforward amount is treated as "paid or accrued" in the succeeding taxable year.

In Notice 2018-28, 2018-16 I.R.B. 492, Section 3, the Treasury Department and the IRS stated that business interest carried forward from a taxable year beginning before January 1, 2018, will be treated in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017, for purposes of section 59A. Under this approach, business interest expense that was initially paid or accrued in a taxable year beginning before January 1, 2018, could nonetheless be a base erosion payment in a taxable year beginning after December 31, 2017, because section 163(j)(2) deems a recurring "payment or accrual" for such item in each carryforward year. Comments requested that the Treasury Department and the IRS reconsider the position taken in Notice 2018-28, on the basis that the determination of whether a payment is a base erosion payment should be made as of the date of the actual payment of interest rather than the date that a deduction is allowed under section 163(j).

The Treasury Department and the IRS agree and have determined that the approach described in Notice 2018-28 is not consistent with the general effective date provision in Section 14401(e) of the Act because the language in section 163(j)(2) deeming a recurring "payment or accrual" is primarily to implement the carryforward mechanism in section 163(j), rather than to treat interest that is carried forward to a subsequent taxable year as paid or accrued for all tax purposes in that subsequent taxable year. Accordingly, the proposed regulations do not follow the approach described in Notice 2018-28. Instead, the proposed regulations provide that any disallowed disqualified interest under section 163(j) that resulted from a payment or accrual to a foreign related party and that is carried forward from a taxable year beginning before January 1, 2018, is not a base erosion payment. The proposed regulations also clarify that any disallowed business interest carryforward under section 163(j) that resulted from a payment or accrual to a foreign related party is treated as a base erosion payment in the year that the interest was paid or accrued even though the interest may be deemed to be paid or accrued again in the year in which it is actually deducted. The rule in the proposed regulations generally is consistent with excluding interest paid or accrued before January 1, 2018 (generally under financing arranged prior to the Act) from treatment as a base erosion payment. The Treasury Department and the IRS welcome comments with respect to the treatment of disallowed disqualified interest under section 163(j) from a taxable year beginning before January 1, 2018. See Part IV.B of this Explanation of Provisions section for proposed rules determining the amount of business interest expense for which a deduction is allowed when section 163(j) applies to limit interest deductions.

IV. Base Erosion Tax Benefits

The amount of base erosion tax benefits is an input in (i) the computation of the base erosion percentage test (discussed in Part II.C of this Explanation of Provisions section) and (ii) the determination of modified taxable income (discussed in Part V of this Explanation of Provisions section). Generally, a base erosion tax benefit is the amount of any deduction relating to a base erosion payment that is allowed under the Code for the taxable year. Base erosion tax benefits are defined in proposed §1.59A-3(c).

A. Withholding Tax on Payments

As discussed in Part II.C of this Explanation of Provisions section, if tax is imposed by section 871 or 881 and the tax is deducted and withheld under section 1441 or 1442 without reduction by an applicable income tax treaty on a base erosion payment, the base erosion payment is treated as having a base erosion tax benefit of zero for purposes of calculating a taxpayer's modified taxable income. If an income tax treaty reduces the amount of withholding imposed on the base erosion payment, the base erosion payment is treated as a base erosion tax benefit to the extent of the reduction in withholding under rules similar to those in section 163(j)(5)(B) as in effect before the Act.

B. Rules for Classifying Interest for which a Deduction is Allowed when Section 163(j) Limits Deductions

Section 59A(c)(3) provides a stacking rule in cases in which section 163(j) applies to a taxpayer, under which the reduction in the amount of deductible interest is treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to related parties. The statute does not provide a rule for determining which portion of the interest treated as paid to related parties (and thus potentially treated as a base erosion payment) is treated as paid to a foreign related person as opposed to a domestic related person. Proposed §1.59A-3(c)(4) provides rules coordinating section 163(j) with the determination of the amount of base erosion tax benefits. This rule provides, consistent with section 59A(c)(3), that where section 163(j) applies to limit the amount of a taxpayer's business interest expense that is deductible in the taxable year, a taxpayer is required to treat all disallowed business interest first as interest paid or accrued to persons who are not related parties, and then as interest paid or accrued to related parties for purposes of section 59A. More specifically, the proposed regulations provide that when a corporation has business interest expense paid or accrued to both unrelated parties and related parties, the amount of allowed business interest expense is treated first as the business interest expense paid to related parties, proportionately between foreign and domestic related parties, and then as business interest expense paid to unrelated parties. Conversely, the amount of a disallowed business interest expense carryforward is treated first as business interest expense paid to unrelated parties, and then as business interest expense paid to related parties, proportionately between foreign and domestic related party business interest expense.

Because section 163(j) and the proposed regulations thereunder provide an ordering rule that allocates business interest expense deductions first to business interest expense incurred in the current year and then to business interest expense carryforwards from prior years (starting with the earliest year) in order to separately track the attributes on a year-by-year layered approach for subchapter C purposes, these proposed regulations follow that convention. Accordingly, the proposed regulations also follow a year-by-year convention in the allocation of business interest expense and carryovers among the related and unrelated party classifications. See also the discussion of singular tax attributes in Part V.A of this Explanation of Provisions section. The proposed regulations adopt a similar approach for business interest expense and excess business interest of a partnership that is allocated to a corporate partner by separately tracking and ordering items allocated from a partnership.

V. Modified Taxable Income

For any taxable year, section 59A imposes a tax on each applicable taxpayer equal to the base erosion minimum tax amount for that year. Section 59A(b)(1) provides that the base erosion minimum tax amount is determined based on an applicable taxpayer's modified taxable income for the taxable year. Part V.A of this Explanation of Provisions section discusses how an applicable taxpayer computes its modified taxable income. Part V.B of this Explanation of Provisions section describes how modified taxable income is calculated if an applicable taxpayer has an overall taxable loss for a taxable year. Finally, Part V.C of this Explanation of Provisions section describes the base erosion percentage that is used when the base erosion percentage of a net operating loss deduction ("NOL deduction") is added back to taxable income for purposes of the modified taxable income calculation.

A. Method of Computation

Section 59A(c)(1) provides that the term modified taxable income means the taxable income of the taxpayer computed under Chapter 1 for the taxable year, determined without regard to base erosion tax benefits and the base erosion percentage of any NOL deduction under section 172 for the taxable year. The proposed regulations clarify that the computation of modified taxable income and the computation of the base erosion minimum tax amount (which is discussed in Part VI of this Explanation of Provisions section) are made on a taxpayer-by-taxpayer basis. That is, under the proposed regulations, the aggregate group concept is used solely for determining whether a taxpayer is an applicable taxpayer and the base erosion percentage of any NOL deduction. This approach is consistent with section 59A(a)'s imposition of a tax equal to the base erosion minimum tax amount, which is in addition to the regular tax liability of a taxpayer.

The proposed regulations also provide that the computation of modified taxable income is done on an add-back basis. The computation starts with taxable income (or taxable loss) of the taxpayer as computed for regular tax purposes, and adds to that amount (a) the gross amount of base erosion tax benefits for the taxable year and (b) the base erosion percentage of any NOL deduction under section 172 for the taxable year.

The proposed regulations do not provide for the recomputation of income under an approach similar to the alternative minimum tax, which the Act repealed for corporations. See section 12001(a) of the Act. Under a recomputation approach, attributes that are limited based on taxable income would be subject to different annual limitations, and those attributes would have to be re-computed for purposes of section 59A. Applying this approach in a manner that reflects the results of the BEAT-basis recomputation to subsequent years would lead to parallel attributes that are maintained separately in a manner similar to the pre-Act corporate alternative minimum tax. For example, the amount of the net operating loss used to reduce modified taxable income would differ from the amount used in computing regular tax liability, and the carryforward of unused net operating loss that is used to compute regular tax liability would not reflect the net operating loss amount used to reduce modified taxable income (absent a separate BEAT-basis carryover). The annual limitation under section 163(j)(1), which generally limits a corporation's annual deduction for business interest expense, would present similar issues under a recomputation approach. Consequently, the add-back approach also provides simplification relative to the recomputation approach because the add-back approach eliminates the need to engage in the more complex tracking of separate attributes on a BEAT basis in a manner similar to the repealed corporate AMT. The Treasury Department and the IRS welcome comments on the add-back approach provided in the proposed regulations, and the practical effects of an alternative recomputation-based approach.

B. Conventions for Computing Modified Taxable Income – Current Year Losses and Excess Net Operating Loss Carryovers

If a taxpayer has an excess of deductions allowed by Chapter 1 over gross income, computed without regard to the NOL deduction, the taxpayer has negative taxable income for the taxable year. Generally, the proposed regulations provide that a negative amount is the starting point for computing modified taxable income when there is no NOL deduction from net operating loss carryovers and carrybacks.

The proposed regulations further provide a rule applicable to situations in which there is a NOL deduction from a net operating loss carryover or carryback to the taxable year and that NOL deduction exceeds the amount of positive taxable income before that deduction (because, for example, the loss arose in a year beginning before January 1, 2018). The proposed regulations provide that the excess amount of NOL deduction does not reduce taxable income below zero for determining the starting point for computing modified taxable income. The Treasury Department and the IRS have determined that this rule is necessary because section 172(a) could be read to provide that, for example, if a taxpayer has a net operating loss of $100x that arose in a taxable year beginning before January 1, 2018, that is carried forward, and in a subsequent year the taxpayer has taxable income of $5x before taking into account the $100x net operating loss carryover deduction, the taxpayer may nonetheless have a $100x NOL deduction in that year or a $95x taxable loss (even though $95x of the net operating loss would remain as a carryforward to future years, as well). Because the proposed regulations recognize the notion of a taxable loss when deductions other than the NOL deduction exceed gross income (as discussed earlier in this Part V), this rule clarifies that the taxpayer's starting point for computing modified taxable income in this situation is zero, rather than negative $95x.

The proposed regulations further clarify that the NOL deduction taken into account for purposes of adding the base erosion percentage of the NOL deduction to taxable income under section 59A(c)(1)(B) is determined in the same manner. Accordingly, in the example above, the base erosion percentage of the NOL deduction added to taxable income is computed based on the $5x NOL deduction that reduces regular taxable income to zero, rather than the entire $100x of net operating loss carryforward, $95x of which is not absorbed in the current taxable year.

Finally, the proposed regulations provide that an applicable taxpayer's taxable income is determined according to section 63(a) without regard to the rule in section 860E(a)(1). That rule generally provides that a holder of a residual interest in a real estate mortgage investment conduit ("REMIC") may not have taxable income less than its excess inclusion amount. As a result of section 860E(a)(1), a holder of a REMIC residual interest may have taxable income for purposes of computing its regular tax liability even though it has a current year loss. The proposed regulations provide that the limitation in section 860E(a)(1) is disregarded for purposes of calculating modified taxable income under section 59A. The rule described in this paragraph is relevant, for example, in situations when the taxpayer would have negative taxable income attributable to a current year loss, as described in this Part V.B, or no taxable income as a result of a net operating loss. Because section 860E(a)(1) ensures that the excess inclusion is subject to tax under section 11, the Treasury Department and the IRS have determined that it is not appropriate to apply the rule in section 860E(a)(1) for the purpose of calculating modified taxable income under section 59A.

C. Conventions for Computing Modified Taxable Income – Determining the Base Erosion Percentage of NOL Deductions

Section 59A(c)(1)(B) provides that modified taxable income includes the base erosion percentage of any NOL deduction allowed under section 172 for the taxable year. In this context, the relevant base erosion percentage could be either the base erosion percentage in the year that the net operating loss arose, or alternatively, the base erosion percentage in the year in which the taxpayer takes the NOL deduction. Proposed §1.59A-4(b)(2)(ii) applies the base erosion percentage of the year in which the loss arose, or vintage year, because the base erosion percentage of the vintage year reflects the portion of base eroding payments that are reflected in the net operating loss carryover. In addition, because the vintage-year base erosion percentage is a fixed percentage, taxpayers will have greater certainty as to the amount of the future add-back to modified taxable income (as compared to using the utilization-year base erosion percentage).

Based on this approach, the proposed regulations also provide that in the case of net operating losses that arose in taxable years beginning before January 1, 2018, and that are deducted as carryovers in taxable years beginning after December 31, 2017, the base erosion percentage is zero because section 59A applies only to base erosion payments that are paid or accrued in taxable years beginning after December 31, 2017. See section 14401(e) of the Act. As a result, there is no add-back to modified taxable income for the use of those net operating loss carryovers. The Treasury Department and the IRS welcome comments on the vintage-year approach as well as the alternative utilization-year approach.

The proposed regulations also clarify that in computing the add-back for NOL deductions for purposes of the modified taxable income calculation, the relevant base erosion percentage is the base erosion percentage for the aggregate group that is used to determine whether the taxpayer is an applicable taxpayer, rather than a separate computation of base erosion percentage computed solely by reference to the single taxpayer.

VI. Base Erosion Minimum Tax Amount

An applicable taxpayer computes its base erosion minimum tax amount ("BEMTA") for the taxable year to determine its liability under section 59A(a). Proposed §1.59A-5 describes the calculation of the BEMTA. Generally, the taxpayer's BEMTA equals the excess of (1) the applicable tax rate for the taxable year ("BEAT rate") multiplied by the taxpayer's modified taxable income for the taxable year over (2) the taxpayer's adjusted regular tax liability for that year. See Part VIII of this Explanation of Provisions section for a discussion of the higher BEAT rate for certain banks and registered securities dealers.

In determining the taxpayer's adjusted regular tax liability for the taxable year, credits (including the foreign tax credit) are generally subtracted from the regular tax liability amount. To prevent an inappropriate understatement of a taxpayer's adjusted regular tax liability, the proposed regulations provide that credits for overpayment of taxes and for taxes withheld at source are not subtracted from the taxpayer's regular tax liability because these credits relate to federal income tax paid for the current or previous year.

For taxable years beginning before January 1, 2026, under section 59A(b)(1)(B), the credits allowed against regular tax liability (which reduce the amount of regular tax liability for purposes of calculating BEMTA) are not reduced by the research credit determined under section 41(a) or by a portion of applicable section 38 credits. For taxable years beginning after December 31, 2025, this special treatment of the research credit and applicable section 38 credits no longer applies. As a result, an applicable taxpayer may have a greater BEMTA than would be the case in taxable years beginning before January 1, 2026. In general, foreign tax credits are taken into account in computing a taxpayer's regular tax liability before other credits. See section 26(a). As a result, a taxpayer with foreign tax credits that reduce its regular tax liability to, or close to, zero may not use its section 41(a) credits or its applicable section 38 credits in computing its regular tax liability. In these situations, those credits will not be taken into account in computing the taxpayer's BEMTA even in a pre-2026 year. Instead, those credits will reduce (or, put differently, will prevent an increase in) the BEMTA in the year when those credits are used for regular tax purposes (provided that the taxable year begins before January 1, 2026).

VII. Application of Section 59A to Partnerships

A partnership is not an "applicable taxpayer" as defined in Section 59A; only corporations can be applicable taxpayers. In general, however, a partnership also is not subject to the income tax imposed by Chapter 1 of Subtitle A of the Code. Instead, partners are liable for income tax only in their separate capacities. Each taxpayer that is a partner in a partnership takes into account separately the partner's distributive share of the partner's income or loss in determining its taxable income. Accordingly, an item of income is subject to federal income taxation based on the status of the partners, and not the partnership as an entity. Similarly, a partnership does not itself benefit from a deduction. Instead, the tax benefit from a deduction is taken by the taxpayer that is allocated the deduction under section 704. Section 702(b) provides that the character of any item be taken into account as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Section 702(b) acknowledges that differences in partner tax characteristics (for example, whether the partner is a corporation or an individual, or domestic or foreign) may result in differences in the tax consequences of items the partnership allocates to its partners.

The proposed regulations generally apply an aggregate approach in conjunction with the gross receipts test for evaluating whether a corporation is an applicable taxpayer and in addressing the treatment of payments made by a partnership or received by a partnership for purposes of section 59A. The proposed regulations generally provide that partnerships are treated as an aggregate of the partners in determining whether payments to or payments from a partnership are base erosion payments consistent with the approach described in subchapter K as well as the authority provided in section 59A(i)(1) to prescribe such regulations that are necessary or appropriate to carry out the provisions of section 59A, including through the use of intermediaries or by characterizing payments otherwise subject to section 59A as payments not subject to 59A. Thus, when determining whether a corporate partner that is an applicable taxpayer has made a base erosion payment, amounts paid or accrued by a partnership are treated as paid by each partner to the extent an item of expense is allocated to the partner under section 704. Similarly, any amounts received by or accrued to a partnership are treated as received by each partner to the extent the item of income or gain is allocated to each partner under section 704. The rules and exceptions for base erosion payments and base erosion tax benefits then apply accordingly on an aggregate basis.

The Treasury Department and the IRS have determined that a rule that applies the aggregate principle consistently is necessary to align the treatment of economically similar transactions. The proposed rule prevents an applicable taxpayer from (a) paying a domestic partnership that is owned by foreign related parties, rather than paying those foreign partners directly, to circumvent the BEAT and (b) causing a partnership in which an applicable taxpayer is a partner to make a payment to a foreign related party, rather than paying that foreign related party directly. The rule applies consistently when a payment is to a foreign partnership that is owned, for example, by domestic corporations. This rule also addresses situations in which a partnership with an applicable taxpayer partner makes a payment to a foreign related party. Partners with certain small ownership interests are excluded from this aggregate approach for purposes of determining base erosion tax benefits from the partnership. This small ownership interests exclusion generally applies to partnership interests that represent less than ten percent of the capital and profits of the partnership and less than ten percent of each item of income, gain, loss, deduction, and credit; and that have a fair market value of less than $25 million. See proposed §1.59A-7(b)(4). The Treasury Department and the IRS determined that a threshold of ten percent appropriately balanced the administrative burdens of determining whether deductions allocated to a partner with a small ownership interest in a partnership are base erosion payments with the Treasury Department and IRS's interest in maintaining a consistent aggregate approach to partnerships in applying to the BEAT. In determining the appropriate threshold for a small ownership interest, the Treasury Department and the IRS considered the treatment of small ownership interests in partnerships in analogous situations in other Treasury regulations. The Treasury Department and the IRS welcome comments on the aggregate approach to partnerships as well as the exception for small ownership interests, including the specific thresholds for the exception.

The proposed regulations do not provide for special treatment of base erosion tax benefits attributable to a partnership or to partnership nonrecognition transactions. Instead, the aggregate principle generally applies to these situations. For example, if a partnership acquires property from a foreign related party of a taxpayer that is a partner in the partnership, deductions for depreciation of the property allocated to the taxpayer generally are base erosion tax benefits. Similarly, if a foreign related party and a taxpayer form a partnership, and the foreign related party contributes depreciable property, deductions for depreciation of the property generally are base erosion tax benefits, in part, because the partnership is treated as acquiring the property in exchange for an interest in the partnership under section 721. This approach is consistent with the approach taken with respect to subchapter C transactions, as described in Part III.A.1 of this Explanation of Provisions section.

The proposed regulations provide that with respect to any person that owns an interest in a partnership, the related party determination under section 59A(g) applies at the partner level.

VIII. Rules Relating to Banks and Dealers for Purposes of Computing the Base Erosion Percentage and Determining the BEAT Rate for Computing BEMTA

Section 59A modifies two general rules in the case of certain banks or registered securities dealers. First, section 59A(e)(1)(C) lowers the base erosion percentage threshold for certain banks and registered securities dealers from three percent or more to two percent or more. See Part II.C of this Explanation of Provisions section for additional discussion of this rule. Second, section 59A(b)(3) provides that the BEAT rate is one percentage point higher for those banks or registered securities dealers.

The proposed regulations do not modify the statutory definition of the term “bank” for these purposes from its reference to section 581, which defines a bank by reference to a bank or trust company incorporated and doing business under the laws of United States (including laws related to the District of Columbia) or of any state. Thus, a foreign corporation licensed to conduct a banking business in the United States and subject to taxation with respect to income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States is not included in this definition.

The proposed regulations clarify that the term "registered securities dealer" is limited to a dealer as defined in section 3(a)(5) of the Securities Exchange Act of 1934 that is registered, or required to be registered, under section 15 of the Securities Exchange Act of 1934.

The proposed regulations also confirm that the operative rules that lower the base erosion percentage threshold and that increase the BEAT rate apply only to a taxpayer that is a member of an affiliated group as defined in section 1504(a)(1), and thus do not apply, for example, if the taxpayer is not affiliated with another includible corporation (within the meaning of section 1504(b)(1)), or if the taxpayer is not itself an includible corporation (for example, a foreign corporation that is an applicable taxpayer).

For purposes of applying the lower base erosion percentage threshold to banks and registered securities dealers, the proposed regulations clarify that because the base erosion percentage is determined on an aggregate group basis, the lower threshold applies if any member of the aggregate 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. This de minimis rule provides that a consolidated group, or a member of the aggregate group of which the taxpayer is a member, is not subject to the lower base erosion percentage threshold if its gross receipts attributable to the bank or the registered securities dealer are less than two percent of the aggregate group's total gross revenue. This de minimis rule uses the same threshold measurement for exclusion from the special rule for banks and registered securities dealers (two percent) that is used as the base erosion percentage threshold for banks or registered securities dealers to determine whether such taxpayers are applicable taxpayers that are subject to the BEAT, with the latter test functioning in a manner similar to a de minimis threshold for the application of the BEAT. See Part II.C of this Explanation of Provisions section. The Treasury Department and the IRS welcome comments on the scope of the de minimis rule for banks and registered securities dealers. See also Part III.B.5 of this Explanation of Provisions section for a discussion of an exception to base erosion payment status for interest on TLAC securities.

IX. Rules Relating to Insurance Companies

The definition of a base erosion payment in section 59A(d) includes any premiums or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments taken into account under section 803(a)(1)(B) or 832(b)(4)(A). Generally, section 803(a)(1) defines gross income for a life insurance company to include the gross amount of premiums and other consideration on insurance and annuity contracts less return premiums and premiums and other consideration arising out of indemnity reinsurance. For an insurance company other than a life insurance company, under section 832(b), gross income generally includes underwriting income, which is comprised of premiums earned during the taxable year less losses incurred and expenses incurred. Section 832(b)(4)(A) provides that the amount of premiums earned on insurance contracts is the amount of gross premiums written on insurance contracts during the taxable year less return premiums and premiums paid for reinsurance.

The Treasury Department and the IRS are aware that certain reinsurance agreements provide that amounts paid to and from a reinsurer are settled on a net basis or netted under the terms of the agreement. The Treasury Department and the IRS are also aware that other commercial agreements with reciprocal payments may be settled on a net basis or netted under the terms of those agreements. The proposed regulations do not provide a rule permitting netting in any of these circumstances because the BEAT statutory framework is based on including the gross amount of deductible and certain other payments (base erosion payments) in the BEAT's expanded modified taxable income base without regard to reciprocal obligations or payments that are taken into account in the regular income tax base, but not the BEAT's modified taxable income base. Generally, the amounts of income and deduction are determined on a gross basis under the Code; however, as discussed in Part III of this Explanation of Provisions section, if there are situations where an application of otherwise generally applicable tax law would provide that a deduction is computed on a net basis (because an item received reduces the item of deduction rather than increasing gross income), the proposed regulations do not change that result. The Treasury Department and the IRS request comments addressing whether a distinction should be made between reinsurance contracts entered into by an applicable taxpayer and a foreign related party that provide for settlement of amounts owed on a net basis and other commercial contracts entered into by an applicable taxpayer and a foreign related party that provide for netting of items payable by one party against items payable by the other party in determining that net amount to be paid between the parties.

The proposed regulations also do not provide any specific rules for payments by a domestic reinsurance company to a foreign related insurance company. In the case of a domestic reinsurance company, claims payments for losses incurred and other payments are deductible and are thus potentially within the scope of section 59A(d)(1). See sections 803(c) and 832(c). In the case of an insurance company other than a life insurance company (non-life insurance company) that reinsures foreign risk, certain of these payments may also be treated as reductions in gross income under section 832(b)(3), which are not deductions and also not the type of reductions in gross income described in sections 59A(d)(3). The Treasury Department and the IRS request comments on the appropriate treatment of these items under subchapter L. The Treasury Department and the IRS also recognize that to the extent that the items are not treated as deductions for non-life insurance companies this may lead to asymmetric treatment for life insurance companies that reinsure foreign risk because part I of subchapter L (the rules for life insurance companies) refers to these costs only as deductions (that is, does not also refer to the costs as reductions in gross income in a manner similar to section 832(b)(3)). The Treasury Department and the IRS request comments on whether the regulations should provide that a life insurance company that reinsures foreign risk is treated in the same manner as a non-life insurance company that reinsures foreign risk.

The proposed regulations do not address a foreign insurance company that has in effect an election to be treated as a domestic corporation for purposes of the Code. Amounts paid or accrued to such a company are not base erosion payments because the corporation is treated as a domestic corporation for purposes of the Code.

X. Anti-Abuse and Recharacterization Rules

Proposed §1.59A-9(b) provides that certain transactions that have a principal purpose of avoiding section 59A will be disregarded or deemed to result in a base erosion payment. This proposed anti-abuse rule addresses the following types of transactions: (a) transactions involving intermediaries acting as a conduit to avoid a base erosion payment; (b) transactions entered into to increase the deductions taken into account in the denominator of the base erosion percentage; and (c) transactions among related parties entered into to avoid the application of rules applicable to banks and registered securities dealers (for example, causing a bank or registered securities dealer to disaffiliate from an affiliated group so as to avoid the requirement that it be a member of such a group).

XI. Consolidated Groups as Taxpayers

Affiliated groups of domestic corporations that elect to file a consolidated income tax return generally compute their income tax liability on a “single-entity” basis.

Because the regular tax liability is computed on a single entity basis, the additional tax imposed by section 59A must also be imposed on the same basis (because it is an addition to that regular tax liability). Accordingly, the proposed regulations provide that for affiliated corporations electing to file a consolidated income tax return, the tax under section 59A is determined at the consolidated group level, rather than determined separately for each member of the group. The BEAT is an addition to the regular corporate income tax under section 11, and the regular corporate income tax is applied to a consolidated group on a consolidated basis. Further, application of the BEAT on a group level eliminates the differences in the aggregate amount of taxation to a consolidated group that would otherwise occur, based on the location of deductions, including, for example, the location of related party interest payments within the group. Accordingly, the BEAT is also applied on a consolidated basis. This single taxpayer treatment for members of a consolidated group applies separately from the aggregate group concept in proposed §1.59A-2(c), which also treats all members of the aggregate group as a single entity, but in that case, only for purposes of applying the gross receipts test and base erosion percentage test for determining whether a particular taxpayer is an applicable taxpayer. See generally, Part II of this Explanation of Provisions section.

To properly reflect the taxable income of the group, consolidated return regulations generally determine the tax treatment of items resulting from intercompany transactions (as defined in §1.1502-13(b)(1)(i)) by treating members of the consolidated group as divisions of a single corporation (single entity treatment). In general, the existence of an intercompany transaction should not change the consolidated taxable income or consolidated tax liability of a consolidated group. Consistent with single entity treatment, items from intercompany transactions are not taken into account for purposes of making the computations under section 59A. For example, any increase in depreciation deductions resulting from intercompany sales of property are disregarded for purposes of determining the taxpayer's base erosion percentage. Similarly, interest payments on intercompany obligations (as defined in §1.1502-13(g)(2)(ii)) are not taken into account in making the computations under section 59A.

XII. Coordinating Consolidated Group Rules for Sections 59A(c)(3) and 163(j)

Section 59A(c)(3) and proposed §1.59A-3(c)(4) coordinate the application of section 163(j) with the determination of the amount of base erosion tax benefits when a taxpayer has business interest expense paid to both unrelated parties and related parties. Those rules provide that, where section 163(j) applies to limit the amount of a taxpayer's business interest that is deductible in a taxable year, the taxpayer is required to treat all disallowed business interest as allocable first to interest paid or accrued to persons who are not related parties, and then to related parties. See Part IV.B of this Explanation of Provisions section.

Proposed §1.1502-59A provides rules regarding application of section 59A(c)(3) to consolidated groups. These rules are required for the allocation of the BEMTA among members of the group under section 1552. In addition, apportionment of the domestic related party status and foreign related party status (defined later in this Part XII) of section 163(j) carryforwards among members of the group is necessary when a member deconsolidates from the group.

The proposed regulations implement the classification approach of proposed §1.59A-3(c)(4) on a consolidated basis (the “classification rule”), to identify which interest deductions are allocable to domestic related party payments, foreign related party payments, and unrelated party payments. Slightly different rules apply to the deduction of current year business interest expense than to the deduction of section 163(j) carryforwards. A consolidated group applies these rules to the amount of business interest expense (either from current year business interest expense or from carryforward amounts) that is actually deducted pursuant to section 163(j) and proposed §§1.163(j)-4(d) and 1.163(j)-5(b)(3). If the group deducts business interest expense paid or accrued in different taxable years (for example, both current year business interest expense and section 163(j) carryforwards), the classification rule applies separately to business interest expense incurred in each taxable year. For purposes of the proposed regulations, a member’s current year business interest expense is the member’s business interest expense that would be deductible in the current taxable year without regard to section 163(j) and that is not a disallowed business interest expense carryforward from a prior taxable year.

The classification rule applies on a single-entity basis to deductions of current year business interest expense. The consolidated group classifies its aggregate business interest deduction from current year business interest expense based on the aggregate current year business interest expense of all types (related or unrelated) paid by members of the group to nonmembers. Business interest deductions are treated as from payments or accruals to related parties first, and then from payments or accruals to unrelated parties. If there are payments to both foreign related parties and domestic related parties, the deductions are classified as to the related parties on a pro-rata basis.

Recognizing the flexibility of related-party financing, these proposed regulations provide that, if the group has aggregate business interest deductions classified as payments or accruals to a domestic related party (domestic related party status) or foreign related party (foreign related party status), the status of such payments or accruals is spread among members of the group (the allocation rule). Specifically, the domestic related party status and foreign related party status of the deduction is allocated among members of the group in proportion to the amount of each member's deduction of its current year business interest expense. Similarly, if any part of a section 163(j) carryforward is from a payment or accrual to a domestic related party or a foreign related party, the related party status of the section 163(j) carryforwards for the year will be allocated among members of the group. The allocation is in proportion to the relative amount of each member's section 163(j) carryforward from that year. Members' additional section 163(j) carryforward amounts are treated as payments or accruals to unrelated parties. The allocation rule applies separately to each carryforward year.

With regard to the deduction of any member's section 163(j) carryforward, the classification rule applies on an entity-by-entity basis. As discussed, before a member's section 163(j) carryforward moves forward into subsequent years, it is allocated a domestic related party status, foreign related party status, or unrelated party status. This allocation ensures that business interest deductions drawn from any carryforward originating in the same consolidated return year bear the same ratio of domestic related, foreign related, and unrelated statuses. When a member deducts any portion of its section 163(j) carryforward, the member applies section 59A(c)(3) and proposed §1.59A-3(c)(4) to determine the status of the deducted carryforward, based on the status previously allocated to the member's section 163(j) carryforward for the relevant tax year. The tax liability imposed under section 59A on the consolidated group is allocated among the members of the consolidated group pursuant to the consolidated group's tax allocation method, taking into account these allocations. See section 1552.

If a member that is allocated a foreign related party status or domestic related party status to its section 163(j) carryforward deconsolidates from the group, the departing member's carryforward retains the allocated status. The departing member (and not the original consolidated group) takes into account the status of that carryforward for purposes of computing the BEAT in future years.

XIII. Consolidated Tax Liability

In §1.1502-2, a reference is added to the base erosion anti-abuse tax as a tax included in the computation of consolidated tax liability. Additionally, the proposed regulations make the following changes: (1) remove paragraph (j) of this regulation section because section 1333, relating to war loss recoveries, was repealed by section 1901(a)(145)(A) of the Tax Reform Act of 1976, Pub. L. 94-455, (2) remove paragraph (h) of this regulation section because section 1201, relating to the alternative tax for corporations, was repealed by section 13001(b)(2)(A) of the Act, and (3) update the cross reference to life insurance taxable income to section 801, following the revision of subchapter L of chapter 1 of the code in section 211 of the Deficit Reduction Act of 1984, Pub. L. 98-369.

In addition, the proposed regulations also make nonsubstantive changes to reorganize the structure of current §1.1502-2. Specifically, the proposed regulations reorganize the current §1.1502-2 to properly designate the unnumbered paragraphs. The proposed regulations also update other regulation sections that reference §1.1502-2.

Finally, the proposed regulations correct an error in §1.6655-5(e) Example 10. The proposed regulations replace the reference to "§1.1502-2(h)" with a reference to "1.1502-1(h)" because the context of Example 10 demonstrates that the intended reference was to the definition of a consolidated group.

XIV. Sections 382 and 383

Section 1.383-1 provides that only otherwise currently allowable pre-change losses and pre-change credits will result in the absorption of the section 382 limitation and the section 383 credit limitation. The limitations under sections 382 and 383 are applied after the application of all other limitations contained in subtitle A of the Code. If the pre-change losses or pre-change credits cannot be deducted or otherwise used, they are carried forward to the next taxable year. The BEAT is not a modification to the normal computation of income tax under Subtitle A of the Code but an addition to that income tax. Therefore, these proposed regulations clarify that additions to tax under section 59A do not affect whether a loss, deduction, or credit is absorbed under section 382 or section 383.

XV. Reporting and Recordkeeping Requirements Pursuant to Section 6038A

Section 6038A imposes reporting and recordkeeping requirements on domestic corporations that are 25-percent foreign-owned. Section 6038C imposes the same reporting and recordkeeping requirements on certain foreign corporations engaged in a U.S. trade or business. These corporations are collectively known as “reporting corporations.”

Reporting corporations are required to file an annual return on Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)*, with respect to each related party with which the reporting corporation has had any "reportable transactions." See §1.6038A-2. Reporting corporations are also subject to specific requirements under sections 6038A and 6038C to maintain and make available the permanent books of account or records as required by section 6001 that are sufficient to establish the accuracy of the federal income tax return of the corporation, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties. See §1.6038A-3.

The Act amended section 6038A by adding paragraph (b)(2), which authorizes regulations requiring information from a reporting corporation that is also a section 59A "applicable taxpayer" for purposes of administering section 59A. Section 6038A(b)(2) applies to taxable years beginning after December 31, 2017. These proposed regulations identify certain types of information that will be required to be reported on Form 5472 and Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*, and also provide the time and manner for reporting. While an applicable taxpayer that is not a reporting corporation would not be subject to monetary penalties and collateral provisions specific to sections 6038A and 6038C, the taxpayer remains subject to BEAT-related reporting obligations, including Form 8991, and applicable consequences for noncompliance.

Under section 59A(d)(4), the status of a foreign shareholder as a surrogate foreign corporation as defined in section 7874(a)(2)(B) or as a member of the same expanded affiliated group, as defined in section 7874(c)(1), as the surrogate foreign corporation can affect the treatment of payments from a taxpayer to that corporation under section 59A(d). If the reporting corporation is an expatriated entity as defined in section 7874(a)(2), the taxation of certain transactions between it and its foreign related persons as defined in section 7874(d)(3) may be affected. Consequently, the proposed regulations require all reporting corporations to state whether a foreign shareholder required to be listed on Form 5472 is a surrogate foreign corporation. The form may provide for reporting of whether the shareholder is a member of an expanded affiliated group including the surrogate foreign corporation.

In addition, to facilitate screening for important tax compliance concerns under section 59A as well as other provisions at the return filing stage, these proposed regulations clarify that the IRS may require by form or by form instructions the following information: (1) reporting of particular details of the reporting corporation's relationships with related parties in regard to which it is required to file a Form 5472, (2) reporting of transactions within certain categories on a more detailed basis, (3) reporting of the manner (such as type of transfer pricing method used) in which the reporting corporation determined the amount of particular reportable transactions and items, and (4) summarization of a reporting corporation's reportable transactions and items with all foreign related parties on a schedule to its annual Form 5472 filing.

XVI. Partial withdrawal of proposed regulations

The proposed regulations also withdraw, in part, a notice of proposed rulemaking. Because of statutory changes in section 12001 of the Act, the proposed regulations would not incorporate the substance of §1.1502-2, relating to the computation of a consolidated group's alternative minimum tax, of the notice of proposed rulemaking (IA-57-89) published in the **Federal Register** on December 30, 1992 (57 FR 62251). Accordingly, the Partial Withdrawal of Proposed Regulations section in this document withdraws that section of the notice of proposed rulemaking.

Proposed Applicability Date

Under section 7805(b)(2), and consistent with the applicability date of section 59A, these regulations (other than the proposed reporting requirements for QDPs in proposed §1.6038A-2(b)(7)) are proposed to apply to taxable years beginning after December 31, 2017. Until finalization, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, provided the taxpayer and all related parties of the taxpayer (as defined in proposed §1.59A-1(b)(17)) consistently apply the proposed regulations for all those taxable years that end before the finalization date.

With respect to the reporting requirements for QDPs, proposed §1.6038A-2(b)(7)(ix) applies to taxable years beginning one year after final regulations are published in the **Federal Register**, although simplified QDP reporting requirements provided in §1.6038A-2(g) are also proposed to apply to taxable years beginning after December 31, 2017.

If any provision is finalized after June 22, 2019, the Treasury Department and the IRS generally expect that such provision will apply only to taxable years ending on or after **[INSERT DATE OF FILING FOR PUBLIC INSPECTION BY THE FEDERAL**

REGISTER]. See section 7805(b)(1)(B).

Special Analyses

Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

The proposed regulations have been designated by the Office of Management and Budget's ("OMB") Office of Information and Regulatory Affairs ("OIRA") as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and OMB regarding review of tax regulations. OIRA has determined that the proposed rulemaking is economically significant under section 1(c) of the Memorandum of Agreement and thereby subject to review. Accordingly, the proposed regulations have been reviewed by OMB.

A. Overview

The proposed regulations provide guidance under section 59A regarding the determination of the tax on base erosion payments for certain taxpayers with substantial gross receipts. They provide guidance for applicable taxpayers to determine the amount of BEAT liability and how to compute the components of the tax calculation. Among other benefits, this clarity helps ensure that all taxpayers apply section 59A in a similar manner, which promotes efficiency and equity with respect to the provisions of the overall Code.

The proposed regulations under sections 59A (proposed §§1.59A-1 through 1.59A-10) provide details for taxpayers regarding whether a taxpayer is an applicable taxpayer and the computation of certain components of the base erosion minimum tax, including the amount of base erosion payments, the amount of base erosion tax benefits arising from base erosion payments, and modified taxable income. The proposed regulations also provide guidance for banks, registered securities dealers, and insurance companies and provide guidance attributing partnership income and deductions involving partnerships to the owners of the partnerships (amounts paid by and to partnerships). These proposed regulations also establish anti-abuse rules to prevent taxpayers from taking measures to inappropriately avoid section 59A.

The proposed regulations under sections 383, 1502 and 6038A (proposed §§1.383-1, 1.502-2, 1.502-59A, 1.6038A-1, 1.6038A-2, and 1.6038-4) provide rules for the application of section 59A with respect to limitations on certain capital losses and excess credits, consolidated groups and their members, and reporting requirements, which include submitting, in certain cases, new Form 8991, Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts. This economic analysis describes the economic benefits and costs of the proposed regulations. The Treasury

Department and the IRS anticipate that any final rule will contain the analysis prescribed by the Memorandum of Agreement (April 11, 2018) between the Treasury Department and OMB.

B. Economic Analysis of the Proposed Regulations

1. Background

Congress was concerned, in part, that foreign-owned U.S. subsidiaries are able to reduce their U.S. tax liability by making deductible payments to a foreign parent or foreign affiliates, eroding the U.S tax base if the payments are subject to little or no U.S. withholding tax. This result may favor foreign-headquartered companies over U.S. headquartered companies, creating a tax-driven incentive for foreign takeovers of U.S. firms and enhancing the pressure for U.S headquartered companies to re-domicile abroad and shift income to low-tax jurisdictions. Senate Committee on Finance, Explanation of the Bill, S. Rpt. 115-20, at 391. Section 59A was introduced, in part, as a minimum tax to prevent excessive reduction in corporate tax liability using deductible and certain other payments to foreign related parties.

The Treasury Department views section 59A as largely self-executing, which means that it is binding on taxpayers and the IRS without any regulatory action. The Treasury Department and the IRS recognize, however, that section 59A, while self-executing, provides interpretive latitude for taxpayers and the IRS that could, without further implementation guidance, prompt a variety of responses. Consequently, many of the details behind the relevant terms and necessary calculations required for the computation of an applicable taxpayer's BEAT liability would benefit from greater specificity. As is expected after the passage of major tax reform legislation, the proposed regulations answer unresolved questions and provide detail and specificity for the definitions and concepts described in section 59A, so that taxpayers can readily and accurately determine if they are applicable taxpayers and, if so, compute their BEMTA. For example, the proposed regulations define the scope of crucial terms such as applicable taxpayer, base erosion payments, base erosion tax benefits, de minimis exemptions, and modified taxable income. Specific examples of where these proposed regulations provide clarification of the statute are discussed in this Part B of the Special Analyses section.

As explained in Part VI of the Explanation of Provisions section, an applicable taxpayer computes its BEMTA for the taxable year to determine its liability under section 59A(a). In general, the taxpayer's BEMTA is equal to the excess of (1) the applicable tax rate for the year at issue multiplied by the taxpayer's modified taxable income over (2) the taxpayer's adjusted regular tax liability for that year. Modified taxable income is a taxpayer's taxable income for the year calculated without regard to any base erosion tax benefit or the base erosion percentage of any allowable net operating loss deductions.

In general, the proposed regulations interpret the statute by answering two important questions: (1) to which taxpayers does the BEAT apply, and (2) how do the rules apply to those taxpayers?

a. Applicable Taxpayer

In order for the BEAT to apply, a taxpayer must be an applicable taxpayer, as described in Part II of the Explanation of Provisions section. In general, an applicable taxpayer is a corporation, other than a RIC, REIT, or an S corporation, that satisfies the gross receipts test and the base erosion percentage test. For purposes of these tests, members of a group of corporations related by stock ownership are aggregated. Section 59A(e)(3) refers to aggregation on the basis of persons treated as a single taxpayer under section 52(a) (controlled group of corporations), which includes both domestic and foreign persons. As discussed in Part II.A of the Explanation of Provisions section, the Treasury Department and the IRS determined that to implement the provisions of section 59A, it was necessary to treat foreign corporations as outside of the controlled group for purposes of applying the aggregation rules, except to the extent that the foreign corporation is subject to net income tax under section 882(a) (tax on income of foreign corporations connected with U.S. business). Upon aggregation of domestic and foreign controlled groups of corporations, intra-aggregate group transactions are eliminated. If aggregation were defined to include both domestic and all foreign persons (i.e., a "single employer" under section 52(a)), this elimination would include most base erosion payments, which are defined by section 59A(d)(1) as "any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowed under this chapter." Without these base erosion payments, virtually no taxpayer or aggregated group would satisfy the base erosion percentage test; thus substantially all taxpayers (or the aggregate group of which the taxpayer was a member) would be excluded from the requirement to pay a tax equal to the BEMTA.

A taxpayer, or the aggregate group of which the taxpayer is a member, satisfies the gross receipts test if it has average annual gross receipts of at least $500 million for the three taxable years ending with the preceding taxable year.

The base erosion percentage test is satisfied if the taxpayer (or aggregated group) has a base erosion percentage of three percent or more. A lower two percent base erosion percentage applies for banks and registered securities dealers. As explained in proposed §1.52A-2(e), the base erosion percentage is computed by dividing (1) the aggregate amount of base erosion tax benefits by (2) the sum of the aggregate amount of deductions plus certain other base erosion tax benefits.

The statute is ambiguous or silent on certain details for determining whether a taxpayer is an applicable taxpayer, including the aggregation rule described in Part II.A. of the Explanation of Provisions section. Absent these proposed regulations, there would be uncertainty among taxpayers as to whether the tax equal to the BEMTA would apply to them. Without guidance, different taxpayers would likely take different positions regarding the determination of their status as an applicable taxpayer, which would result in inefficient decision-making and inconsistent application of the statute as taxpayers engage in corporate restructurings, or adjust investment and spending policies based on tax planning strategies to manage BEAT liability (as discussed in this

Part B.2.b. of the Special Analyses section). The proposed regulations provide clarity by (1) defining the aggregate group to which the gross receipts and base erosion percentage tests apply, and (2) providing guidance on the definitions and computations necessary to apply those tests.

b. BEAT Calculation

Part III of the Explanation of Provisions section discusses the rules regarding the types of payments that are base erosion payments (as defined in proposed §1.52A-3(b)). Section 59A(d)(5) provides an exception from the definition of a base erosion payment for an amount paid or accrued by a taxpayer for services if the services are eligible for the services cost method under section 482 (without regard to certain requirements under the section 482 regulations) and the amount constitutes the total services cost with no markup component. The statute is ambiguous as to whether the SCM exception (1) does not apply to a payment or accrual that includes a markup component, or (2) does apply to such a payment or accrual that includes a markup component, but only to the extent of the total services costs. The proposed regulations follow the latter approach as discussed in Part B.2.b. of this Special Analyses section.

As discussed in Part III.B.3 of the Explanation of Provisions section, the proposed regulations provide an exception from the definition of base erosion payment for payments to the U.S. branch of a foreign person to the extent that payments to the foreign related party are treated as effectively connected income. In general, whether a payment is a base erosion payment is determined based on whether the recipient is a foreign person (as defined in section 6038A(c)(3)) and a related party, and whether the payment is deductible to the payor. See section 59A(f). A foreign person means any person who is not a United States person. However, as discussed in Part III.B.3. of the Explanation of Provisions section, the Treasury Department and the IRS determined that establishing whether a payment is a base erosion payment based solely on the status of the recipient as a foreign person is inconsistent with the statute's intent of eliminating base erosion. Deductible payments to a foreign person that are treated as effectively connected income are subject to tax under section 871(b) and 882(a) in substantially the same manner as payments to a U.S. citizen or resident, or a domestic corporation, and, thus, such payments do not result in base erosion. Proposed §1.52A-3(b)(3)(iii) adopts an exception for such amounts.

As described in this Part B.1. of the Special Analyses section, modified taxable income is a taxpayer's taxable income for the year calculated without regard to any base erosion tax benefit or the base erosion percentage of any allowable net operating loss deductions under section 172 (net operating loss deduction). As discussed in Part V.A. of the Explanation of Provisions section, modified taxable income is not calculated by recomputing the tax base without base erosion tax benefits under an approach similar to the alternative minimum tax, which the Act repealed for corporations. To do so would require taxpayers to maintain records for separate carryforward balances for attributes, such as net operating loss deductions and business interest expense carryovers. These items are limited based on taxable income, so under the recomputation or alternative minimum tax-approach, there would most likely be different annual limitations and other computational differences for regular tax purposes and section 59A purposes.

As discussed in Part VII of the Explanation of Provisions section, the proposed regulations apply the aggregate approach to base erosion payments involving partnerships because partnerships are pass-through entities that are not themselves subject to U.S. income tax, but rather the income of the partnership is taxed to the partners in the partnership. Accordingly, the proposed regulations provide that payments by a corporation to a partnership, and payments by a partnership to a corporation, are treated in the first instance as payments to the partners in the partnership and in second instance as payments by the partners in the partnership. For example, in the absence of this aggregate approach rule, a payment by an applicable taxpayer (corporation) to a related foreign partnership could be a base erosion payment even if all of the partners in the partnership are domestic persons. Under this rule, which applies an aggregate approach to partnerships, the payment by the applicable taxpayer (corporation) to a related foreign partnership is only treated as a base erosion payment to the extent that the partners in the foreign partnership are themselves foreign related parties. Conversely, also in the absence of this aggregate approach rule, a payment by an applicable taxpayer (corporation) to a related domestic partnership could not be a base erosion payment even if some or all of the partners in the partnership are foreign related parties. Under the aggregate approach, the payment by an applicable taxpayer (corporation) to a related domestic partnership is treated as a base erosion payment to the extent that the partners in the domestic partnership are foreign related parties. This approach is thus neutral in both preventing potential abuse and preventing potential over breadth. The regulations thus eliminate a distortion that would otherwise be present if the status of base erosion payments is made by reference to the partnership, rather than by reference to the partners. For example, in the absence of the proposed regulations, taxpayers might be incentivized to route payments through a domestic partnership that is formed by foreign persons as an intermediary to avoid the BEAT. Conversely, in the absence of the proposed regulations, taxpayers would be incentivized to restructure to avoid making any payments to a foreign partnership that has partners that are solely domestic because such payment could be inappropriately classified as a base erosion payment. The Treasury Department requests comments on the approach to partnerships in the proposed regulations.

c. Anti-abuse and Reporting Requirements

Section 59A(i) provides the Secretary authority to issue regulations and other guidance to prevent the avoidance of the purposes of section 59A. As such, proposed §1.59A-9 provides rules recharacterizing certain specified transactions as necessary to prevent the avoidance of section 59A, and provides examples.

The proposed regulations also provide reporting requirements necessary to properly administer and enforce section 59A. In particular, the Treasury Department and the IRS have identified certain types of information from taxpayers who are applicable taxpayers for purposes of section 59A that will be required to be reported on Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code), and a new Form 8991, Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts. Further detail regarding anticipated paperwork burdens can be found in Part C (Paperwork Reduction Act) of this Special Analyses section, which includes a link to draft forms and guidance for providing comment on the proposed forms.

2. Anticipated Benefits and Costs of the Proposed Regulations

a. Baseline

The Treasury Department and the IRS have assessed the impacts, benefits, and costs of the proposed regulations against a "no action" baseline that reflects projected tax-related and other behavior in the absence of the proposed regulations.

The Treasury Department projects that the proposed regulations will have a non-revenue effect on the economy of at least $100 million per year ($2018) measured against this baseline. The Treasury Department requests comments on this conclusion.

b. Anticipated Benefits

The Treasury Department and IRS expect that the certainty and clarity provided by these proposed regulations, relative to the baseline, will enhance U.S. economic performance under the statute. Because a tax has not previously been imposed on base-eroding payments in this manner and the statute is silent on certain aspects of definitions and calculations, taxpayers can particularly benefit from enhanced specificity regarding the relevant terms and necessary calculations they are required to apply under the statute. In the absence of this enhanced specificity, similarly situated taxpayers might interpret the statutory rules of section 59A differently. For example, different taxpayers might pursue intercompany investment and payment policies based on different assumptions about whether such investments and payments are base eroding payments subject to section 59A, and some taxpayers may forego specific investments and payments that other taxpayers deem worthwhile based on different interpretations of the tax consequences alone. The guidance provided in these proposed regulations helps to ensure that taxpayers face more uniform incentives when making economic decisions, a tenet of economic efficiency. Consistent reporting across taxpayers also increases the IRS's ability to consistently enforce the tax rules, thus increasing equity and decreasing opportunities for tax evasion.

For example, as described in Part III.B.3 of the Explanation of Provisions section, the proposed regulations exclude from base erosion payments those payments made to a foreign related party that are treated as effectively connected income of the foreign payee. Such payments are treated as income to the recipient and subject to U.S. tax, substantially similar to any payment between related U.S. corporations. The payments are not base eroding because their receipt is taxable by the United States. Further, treatment of effectively connected income payments to a foreign related party would produce different tax results for two similarly situated U.S. taxpayers. That is, if the taxpayer were to make a payment to a related U.S. corporation, the payment generally would not be subject to the BEAT, but if a taxpayer were to make a payment to a foreign person with respect to its effectively connected income, it would give rise to BEAT liability, despite the fact that in both cases the recipients include the payment in U.S. taxable income.

The Treasury Department and the IRS also considered the benefits and costs of providing the specific proposed terms, calculations, and other details regarding the BEAT. In developing these proposed regulations, the Treasury Department and the IRS have generally aimed to apply the principle that an economically efficient tax system would treat income derived from similar economic decisions similarly, to the extent consistent with the statute and considerations of administrability of the tax system. For example, as noted in Part B.1.b. of this Special Analyses section, section 59A(d)(5) provides an exception to the definition of a base erosion payment for certain payments made to foreign related parties for services that meet the eligibility requirements for use of the SCM (under section 482). The proposed regulations adopt an approach that allows an SCM exception for the total cost of services even if there is a profit markup so long as a transaction meets certain other requirements for using the SCM (under section 482). The proposed regulations provide that the portion of any payment that exceeds the total cost of services is not eligible for the SCM exception and is a base eroding payment.

Alternatives would have been to disallow the SCM exception for the entire amount of any payment that includes a markup component, or to not provide any guidance at all regarding the SCM exception. The Treasury Department and the IRS rejected the former approach. The section 482 regulations mandate intercompany pricing under an "arm's length standard." Under specific circumstances, the section 482 regulations provide that intercompany payments for services can be set by a taxpayer at the cost of providing the service with no profit markup. However, the section 482 regulations prohibit use of this cost-only SCM approach for services "that contribute significantly to fundamental risks of business success or failure" (the "business judgment rule"). See §1.482-9(b)(5). At arm's length, such services would generally be priced to include a profit element to satisfy the market's demand for, and supply of, services among recipients and providers. Section 59A(d)(5)(A) explicitly allows an exception from the BEAT for services that would be eligible for the SCM, "determined without regard to [the business judgment rule]." By allowing an exception from the BEAT for intercompany service payments that do not include a profit markup (i.e., under the SCM transfer pricing method), but also for intercompany service payments that must apply a different transfer pricing method, and therefore generally would include a profit markup at arm's length (i.e., those subject to the business judgment rule), the statute creates ambiguity about the SCM exception's application with respect to the portion of intercompany prices paid for services reflecting the cost of providing the services when there is also a mark-up component.

To promote the consistent application by taxpayers of a SCM exception to the BEAT, and to provide greater clarity, the proposed regulations provide that the SCM exception is available if there is a profit markup (provided that other requirements are satisfied), but the portion of any payment exceeding cost is not eligible for the SCM exception. The Treasury Department and the IRS also rejected the option of not providing any guidance at all regarding the SCM exception because if taxpayers relied on statutory language alone, taxpayers would adopt different approaches due to ambiguity in the statute, leaving it open to differing statutory interpretations and an inconsistent application of the statute. The Treasury Department and IRS expect that approximately one-half of taxpayers filing Form 8991 would avail themselves of the SCM exception. The Treasury Department and the IRS request comments about application of the SCM exception.

As discussed in Part V.A of the Explanation of Provisions section, the Treasury Department and the IRS also considered alternatives regarding the method by which modified taxable income could be calculated for purposes of the BEAT. The proposed regulations could have followed an add-back approach or an approach more similar to that used for the alternative minimum tax. As noted in Part B.1.b. of this Special Analyses section, the proposed regulations adopt the former approach, which is expected to be less costly for taxpayers to apply since taxpayers will not have to recompute their entire tax return on a different basis, or maintain separate sets of records to track annual limitations on attributes such as net operating loss carryforwards or business interest expense carryforwards.

In addition, the proposed regulations clarify that the computations of modified taxable income and BEMTA are done on a taxpayer-by-taxpayer basis. That is, the aggregate group concept is used solely for determining whether a taxpayer is an applicable taxpayer, and does not apply to the computations of modified taxable income and the BEMTA. In the absence of these clarifying definitions, taxpayers could calculate the BEMTA differently depending on their differing views of the base on which the BEAT should be calculated (i.e., aggregated group, consolidated group, individual company), leading to inequitable results across otherwise similar taxpayers. Under the proposed regulations' approach for the calculation of modified taxable income and BEMTA, it is also expected to be less costly for taxpayers to calculate BEMTA since the statutory framework of section 59A applies in addition to the regular tax liability of a taxpayer. Calculation of BEAT liability at an aggregate level, for example, would require taxpayers to first aggregate regular taxable liabilities of the different taxpayers, calculate the BEMTA on an aggregated basis, and then reallocate any BEAT liability among the separate taxpayers. The approach of the proposed regulations, which clarify that the tax should be calculated on a separate taxpayer basis, simplifies these calculations.

The proposed regulations also include de minimis thresholds for partnerships and for registered securities dealers. In general, such thresholds reduce compliance costs for the large number of small taxpayers that would fall below such threshold without substantially affecting the BEAT base. For the de minimis exception for banks and registered securities dealers, in the absence of an exception, affiliated groups that are not principally engaged in banking or securities dealing would be incentivized to alter their business structure to eliminate minimal banks or registered securities dealers from their aggregate groups. These changes would give rise to tax-motivated, inefficient restructuring costs. A de minimis threshold reduces this potential inefficiency again without substantially affecting the BEAT base. In both cases, the thresholds were chosen to balance these competing concerns and to adhere to generally similar standards elsewhere in the Code. The Treasury Department and IRS request comment on the impact of this approach.

3. Anticipated impacts on administrative and compliance costs

Because the statute requires payment of tax regardless of the issuance of regulations or instructions, the new forms, revisions to existing forms, and other proposed regulations can lower the burden on taxpayers of determining their tax liability. The Treasury Department and the IRS expect that the proposed regulations will reduce the costs for taxpayers to comply with the Act, on balance, relative to the baseline of no promulgated regulations.

Certain record-keeping requirements added by the proposed regulations derive directly from statutory changes that require information from a reporting corporation that is also a section 59A applicable taxpayer. Proposed §1.6038A-2 increases recordkeeping requirements for taxpayers because additional information is to be reported on Form 5472 and Form 8991.

Proposed §1.59A-3(b)(3) also increases record-keeping requirements for taxpayers because additional information is required for taxpayers to satisfy a regulatory requirement of the SCM exception. The requirement added by these proposed regulations is consistent with the requirements for eligibility for the services cost method under section 482, including the existing requirements of §1.482-9(b).

C. Paperwork Reduction Act

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

The collections of information in these proposed regulations with respect to section 59A are in proposed §§1.59-3(b)(3) and 1.6038A-2. The information collection requirements pursuant to proposed §1.59A-3(b)(3)(i)(C) are discussed further below. The IRS intends that the collections of information pursuant to section 59A, except with respect to information collected under proposed §1.59A-3(b)(3), will be conducted by way of the following:

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

Trade or Business;

- Revised Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities.

For purposes of the Paperwork Reduction Act, the reporting burden associated with the collections of information with respect to section 59A, other than with respect to proposed §1.59A-3(b)(3), will be reflected in the IRS Forms 14029 Paperwork Reduction Act Submission, associated with Forms 5471 (OMB control numbers 1545-0123, and 1545-0074), 5472 (OMB control number 1545-0123), 8858 (OMB control numbers 1545-0123, 1545-0074, and 1545-1910), and 8991 (OMB control number 1545-0123).

The current status of the Paperwork Reduction Act submissions related to BEAT is provided in the following table. The BEAT provisions are included in aggregated burden estimates for the OMB control numbers listed below which, in the case of 1545-0123, represents a total estimated burden time, including all other related forms and schedules for corporations, of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017) and, in the case of 1545-0074, a total estimated burden time, including all other related forms and schedules for individuals, of 1.784 billion hours and total estimated monetized costs of $31.764 billion ($2017). The burden estimates provided in the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and will in the future include but not isolate the estimated burden of only the BEAT requirements. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the proposed regulations. The Treasury Department and IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burden that international tax provisions imposed prior to TCJA. No burden estimates specific to the proposed regulations are currently available. The Treasury Department has not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. Those estimates would capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations. The Treasury Department and the IRS request comment on all aspects of information collection burdens related to the proposed regulations. In addition, when available, drafts of IRS forms are posted for comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm.

<table>
<tr><th>Form</th><th>Type of Filer</th><th>OMB Number(s)</th><th>Status</th></tr>
<tr><td rowspan="4">Form 5471 (including Schedule G)</td><td>Business (NEW Model)</td><td>1545-0123</td><td>Published in the FRN on 10/8/18. Public Comment period closes on 12/10/18.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</td></tr>
<tr><td>Individual (NEW Model)</td><td>1545-0074</td><td>Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3/2019. 60 Day FRN not published yet for full collection.</td></tr>
<tr><td colspan="3">Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031</td></tr>
<tr><td>Form 5472 (including Part</td><td>Business (NEW</td><td>1545-0123</td><td>Published in the FRN on 10/11/18. Public Comment period closes on 12/10/18.</td></tr>
</table>

Form	Type of Filer	OMB Number(s)	Status
VIII)	Model)		
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		
Form 8858	All other Filers (mainly trusts and estates) (Legacy system)	1545-1910	Published in the FRN on 10/30/18. Public Comment period closes on11/30/18. ICR in process by the Treasury Department as of 9/6/18.
	Link: https://www.federalregister.gov/documents/2018/10/30/2018-23644/agency-information-collection-activities-submission-for-omb-review-comment-request-multiple-irs		
	Business (NEW Model)	1545-0123	Published in the FRN on 10/8/18. Public Comment period closes on 12/10/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		
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	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031		
Form 8991	Business (NEW Model)	1545-0123	Published in the FRN on 10/11/18. Public Comment period closes on 12/10/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		

Related New or Revised Tax Forms

	New	Revision of existing form	Number of respondents (2018, estimated)
Form 8991	Y		3,500 – 4,500

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

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

2. Collection of Information – Proposed §1.59A-3(b)(3)

In contrast to the collections of information pursuant to other provisions of section 59A (as discussed above), the IRS intends that the information collection requirements pursuant to proposed §1.59A-3(b)(3)(i)(C) will be satisfied by the taxpayer maintaining permanent books and records that are adequate to verify the amount charged for the services and the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of the services, calculation of the amount of profit mark-up (if any) paid for the services, and sufficient documentation to allow verification of the methods used to allocate and apportion the costs to the services.

The collection of information contained in proposed §1.59A-3(b)(3) has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1994 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by **[INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].**

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the duties of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (including underlying assumptions and methodology);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

The collection of information in proposed §1.59A-3(b)(3) is mandatory for taxpayers seeking to exclude certain amounts paid or accrued to a foreign related party for services from treatment as base erosion payments for purposes of section 59A (the "SCM exception to the BEAT", as discussed this Part B.2.b. of the Special Analyses section). Taxpayers seeking to rely on the SCM exception to the BEAT are aggregate groups of corporations with average annual gross receipts of at least $500 million and that make payments to foreign related parties. The information required to be maintained will be used by the IRS for tax compliance purposes.

Estimated total annual reporting burden: 5,000 hours.

Estimated average annual burden hours per respondent: 2.5 hours.

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

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

Estimated annual frequency of responses: Once.

Based on these estimates, the annual three-year reporting burden for those electing the SCM exemption is $0.16 mn/yr ($2017) ($238 x 2000/3, converted to millions).

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

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

D. Regulatory Flexibility Act

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

Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public about the impact of this proposed rule on small entities.

Pursuant to section 7805(f), these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

E. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

F. Executive Order 13132: Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Request for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules.

All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Statement of Availability of IRS Documents

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

Drafting Information

The principal authors of the proposed regulations are Sheila Ramaswamy and Karen Walny of the Office of Associate Chief Counsel (International) and Julie Wang and John P. Stemwedel of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

Partial Withdrawal of Proposed Regulations

Accordingly, under the authority of 26 U.S.C. 7805 and 26 U.S.C. 1502, §1.1502-2 of the notice of proposed rulemaking (IA-57-89) published in the **Federal Register** on December 30, 1992 (57 FR 62251) is withdrawn.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

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

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

* * * * *

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

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

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

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

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

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

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

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

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

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

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

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

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

§§1.6038A-2(a)(3) and (b)(7) also issued under 26 U.S.C. 6038A(b)(2).

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Par. 2. Sections 1.59A-1 through 1.59A-10 are added to read as follows:

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

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

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

(1) Aggregate group. The term aggregate group means the group of corporations determined by--

(i) Identifying a controlled group of corporations as defined in section 1563(a), except that the phrase “more than 50 percent” is substituted for “at least 80 percent” each place it appears in section 1563(a)(1) and the determination is made without regard to sections 1563(a)(4) and (e)(3)(C), and

(ii) Once the controlled group of corporations is determined, excluding foreign corporations except with regard to income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or regulations published under 26 CFR chapter I. Notwithstanding the foregoing, if a foreign corporation determines its net taxable income under an applicable income tax treaty of the United States, it is excluded from the controlled group of corporations except with regard to income taken into account in determining its net taxable income.

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

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

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

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

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

(4) Bank. The term bank means an entity defined in section 581.

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

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

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

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

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

(10) Foreign person. The term foreign person means any person who is not a United States person. For purposes of the preceding sentence, a United States person has the meaning provided in section 7701(a)(30), except that any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States is not a United States person. See §1.59A-7(b) for rules applicable to partnerships.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(B) Section 318(a)(3)(A) through (C) are not applied so as to consider a United States person as owning stock that is owned by a person who is not a United States person.

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

(19) TLAC securities amount. The term TLAC securities amount is the sum of the adjusted issue prices (as determined for purposes of §1.1275-1(b)) of all TLAC securities issued and outstanding by the taxpayer.

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

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

§1.59A-2 Applicable taxpayer.

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

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

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

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

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

(c) Aggregation rules. A taxpayer that is a member of an aggregate group determines its gross receipts and its base erosion percentage on the basis of the aggregate group as of the end of the taxpayer's taxable year. For these purposes, transactions that occur between members of the taxpayer's aggregate group that were members of the aggregate group as of the time of the transaction are not taken into account. In the case of a foreign corporation that is a member of an aggregate group, only transactions that relate to income effectively connected with, or treated as effectively connected with, the conduct of a trade or business in the United States are disregarded for this purpose. In the case of a foreign corporation that is a member of an aggregate group and that determines its net taxable income under an applicable income tax treaty of the United States, only transactions that are taken into account in determining its net taxable income are disregarded for this purpose.

(d) Gross receipts test--(1) Amount of gross receipts. A taxpayer, or the aggregate group of which the taxpayer is a member, satisfies the gross receipts test if it has average annual gross receipts of at least $500,000,000 for the three-taxable-year period ending with the preceding taxable year.

(2) Period for measuring gross receipts for an aggregate group--(i) Calendar year taxpayers that are members of an aggregate group. In the case of a corporation that has a calendar year and that is a member of an aggregate group, the corporation applies the gross receipts test in paragraph (d)(1) of this section on the basis of the gross receipts of the aggregate group for the three-calendar-year period ending with the preceding calendar year, without regard to the taxable year of any other member of the aggregate group.

(ii) Fiscal year taxpayers that are members of an aggregate group. In the case of a corporation that has a fiscal year and that is a member of an aggregate group, the corporation applies the gross receipts test in paragraph (d)(1) of this section on the basis of the gross receipts of the aggregate group for the three-fiscal-year period ending with the preceding fiscal year of the corporation, without regard to the taxable year of any other member of the aggregate group.

(3) Gross receipts of foreign corporations. With respect to any foreign corporation, only gross receipts that are taken into account in determining income that is

effectively connected with the conduct of a trade or business within the United States are taken into account for purposes of paragraph (d)(1) of this section. In the case of a foreign corporation that is a member of an aggregate group and that determines its net taxable income under an applicable income tax treaty of the United States, the foreign corporation includes only gross receipts that are attributable to transactions taken into account in determining its net taxable income.

(4) Gross receipts of an insurance company. 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.

(5) Gross receipts from partnerships. See §1.59A-7(b)(5)(ii).

(6) Taxpayer not in existence for entire three-year period. If a taxpayer was not in existence for the entire three-year period referred to in paragraph (d)(1) of this section, the taxpayer determines a gross receipts average for the period that it was in existence, taking into account paragraph (d)(7) of this section.

(7) Treatment of short taxable year. If a taxpayer has a taxable year of fewer than 12 months (a short period), gross receipts are annualized by multiplying the gross receipts for the short period by 365 and dividing the result by the number of days in the short period.

(8) Treatment of predecessors. For purposes of determining gross receipts under this paragraph (d), any reference to a taxpayer includes a reference to any predecessor of the taxpayer. For this purpose, a predecessor includes the distributor or transferor corporation in a transaction described in section 381(a) in which the taxpayer is the acquiring corporation.

(9) Reductions in gross receipts. Gross receipts for any taxable year are reduced by returns and allowances made during that taxable year.

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

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

(2) Base erosion percentage test for banks and registered securities dealers--(i) In general. A taxpayer that is a member of an affiliated group (as defined in section 1504(a)(1)) that includes a bank (as defined in §1.59A-1(b)(4)) or a registered securities dealer (as defined in section §1.59A-1(b)(15)) satisfies the base erosion percentage test if its base erosion percentage is two percent or higher.

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

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

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

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

(B) The sum of--

(1) The aggregate amount of the deductions (including deductions for base erosion tax benefits described in §1.59A-3(c)(1)(i) and base erosion tax benefits described in §1.59A-3(c)(1)(ii)) allowable to the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, any member of the aggregate group) under chapter 1 of Subtitle A for the taxable year;

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

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

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

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

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

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

(D) Any exchange loss within the meaning of §1.988-2 from a section 988 transaction as described in §1.988-1(a)(1);

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

(F) Any deduction not allowed in determining taxable income from the taxable year.

(iii) Effect of treaties on base erosion percentage determination. In computing the base erosion percentage, the amount of the base erosion tax benefit with respect to a base erosion payment on which tax is imposed by section 871 or 881 and with respect to which tax has been deducted and withheld under section 1441 or 1442 is equal to the gross amount of the base erosion tax benefit before the application of the applicable treaty multiplied by a fraction equal to—

(A) The rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty; over

(B) The rate of tax imposed without regard to the treaty.

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

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

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

(vii) Computing the base erosion percentage when members of an aggregate group have different taxable years--(A) Calendar year taxpayers that are members of an aggregate group. In the case of a taxpayer that has a calendar year and that is a member of an aggregate group, the taxpayer applies the base erosion percentage in paragraph (e)(1) or (2) of this section (and determines the base erosion percentage used in §1.59A-4(b)(2)(ii)) on the basis of the base erosion percentage for the calendar year in the manner set forth in paragraph (e)(3) of this section, without regard to the taxable year of any other member of the aggregate group. See paragraph (f)(2) of this section (Example 2) for an illustration of this rule. For purposes of applying paragraph (e)(3)(vi) of this section, all members of the aggregate group are treated as having a calendar year.

(B) Fiscal year taxpayers that are members of an aggregate group. In the case of a taxpayer that has a fiscal year and that is a member of an aggregate group, the taxpayer applies the base erosion percentage test in paragraph (e)(1) or (2) of this section (and determines the base erosion percentage used in §1.59A-4(b)(2)(ii)) on the basis of the base erosion percentage for its fiscal year in the manner set forth in paragraph (e)(3) of this section, without regard to the taxable year of any other member of the aggregate group. See paragraph (f)(2) of this section (Example 2) for an illustration of this rule. For purposes of applying paragraph (e)(3)(vi) of this section, all members of the aggregate group are treated as having the taxpayer's fiscal year.

(C) Transition rule for aggregate group members with different taxable years. For purposes of this paragraph (e)(3)(vii), if the taxpayer has a different taxable year than another member of the taxpayer's aggregate group, each taxpayer that is a member of the aggregate group determines the availability of the exception in §1.59A-

3(b)(3)(vi) (amounts paid or accrued in taxable years beginning before January 1, 2018) by using the taxpayer's taxable year for all members of the taxpayer's aggregate group.

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

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

(1) Example 1: Mark-to-market. (i) Facts. (A) Foreign Parent (FP) is a foreign corporation that owns all of the stock of domestic corporation (DC) and foreign corporation (FC). FP and FC are foreign related parties of DC under §1.59A-1(b)(12) but not members of the aggregate group. DC is a registered securities dealer that does not hold any securities for investment. On January 1 of year 1, DC enters into two interest rate swaps for a term of two years, one with unrelated Customer A as the counterparty (position A) and one with unrelated Customer B as the counterparty (position B). Each of the swaps provides for semiannual periodic payments to be made or received on June 30 and December 31. No party makes any payment to any other party upon initiation of either of the swaps (that is, they are entered into at-the-money). DC is required to mark-to-market positions A and B for federal income tax purposes. DC is a calendar year taxpayer.

(B) For position A in year 1, DC makes a payment of $150 on June 30, and receives a payment of $50 on December 31. There are no other payments in year 1.

On December 31, position A has a value to DC of $110 (that is, position A is in-the-money by $110).

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

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

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

(2) Example 2: Determining gross receipts test and base erosion percentage when aggregate group members have different taxable years. (i) Facts. Foreign Parent (FP) is a foreign corporation that owns all of the stock of a domestic corporation that uses a calendar year (DC1) and a domestic corporation that uses a fiscal year ending on January 31 (DC2). FP does not have income effectively connected with the conduct of a trade or business within the United States. DC2 is a member of DC1's aggregate group, and DC1 is a member of DC2's aggregate group.

(ii) Analysis. (A) For DC1's tax return filed for the calendar year ending December 31, 2026, DC1 determines its gross receipts based on gross receipts of DC1 and DC2 for the calendar years ending December 31, 2023, December 31, 2024, and December 31, 2025. Further, DC1 determines its base erosion percentage for the calendar year ending December 31, 2026, on the basis of transactions of DC1 and DC2 for the calendar year ending December 31, 2026.

(B) For DC2's tax return filed for the fiscal year ending January 31, 2027, DC2 determines its gross receipts based on gross receipts of DC2 and DC1 for the fiscal years ending January 31, 2024, January 31, 2025, and January 31, 2026. Further, DC2 determines its base erosion percentage for the fiscal year ending January 31, 2027, on the basis of transactions of DC2 and DC1 for the fiscal year ending January 31, 2027.

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

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

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

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

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

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

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

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

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

(2) Operating rules--(i) Amounts paid or accrued in cash and other consideration. For purposes of paragraph (b)(1) of this section, an amount paid or accrued includes an amount paid or accrued using any form of consideration, including cash, property, stock, or the assumption of a liability.

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

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

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

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

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

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

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

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

(3) A regulated investment company (as defined in §1.851-1(a)) that pays, or is deemed to pay, a dividend to a specified foreign related party for which a deduction is allowed under section 561.

(D) Specified foreign related party. For purposes of this paragraph (b)(2)(v), specified foreign related party means, with respect to a specified domestic passthrough, any foreign related party of an applicable taxpayer that is a direct or indirect beneficiary or shareholder of the specified domestic passthrough.

(vi) Transfers of property to related taxpayers. If a taxpayer owns property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation) with respect to which paragraph (c)(1)(ii) of this section applies, and the taxpayer sells, exchanges, or otherwise transfers the property to another taxpayer that is a member of an aggregate group that includes the taxpayer, any deduction for depreciation (or amortization in lieu of deprecation) by the transferee taxpayer remains subject to paragraph (c)(1)(ii) of this section to the same extent the amounts would have been so subject in the hands of the transferor. See paragraph (d)(7) of this section (Example 7) for an illustration of this rule.

(3) Exceptions to base erosion payment. Paragraph (b)(1) of this section does not apply to the types of payments or accruals described in paragraphs (b)(3)(i) through (vii) of this section.

(i) Certain services cost method amounts--(A) In general. Amounts paid or accrued by a taxpayer to a foreign related party for services that meet the requirements in paragraph (b)(3)(i)(B) of this section, but only to the extent of the total services cost of those services. Thus, any amount paid or accrued to a foreign related party in excess of the total services cost of services eligible for the services cost method exception (the mark-up component) remains a base erosion payment. For this purpose, services are an activity as defined in §1.482-9(l)(2) performed by a foreign related party (the renderer) that provides a benefit as defined in §1.482-9(l)(3) to the taxpayer (the recipient).

(B) Eligibility for the services cost method exception. To be eligible for the services cost method exception, all of the requirements of §1.482-9(b) must be satisfied, except that:

(1) The requirements of §1.482-9(b)(5) do not apply for purposes of determining eligibility for the service cost method exception in this section; and

(2) Adequate books and records must be maintained as described in paragraph (b)(3)(i)(C) of this section, instead of as described in §1.482-9(b)(6).

(C) Adequate books and records. Permanent books of account and records must be maintained for as long as the costs with respect to the services are incurred by the renderer. The books and records must be adequate to permit verification by the Commissioner of the amount charged for the services and the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of the services, calculation of the amount of profit mark-up (if any) paid for the services, and sufficient documentation to allow verification of the methods used to allocate and apportion the costs to the services in question in accordance with §1.482-9(k).

(D) Total services cost. For purposes of this section, total services cost has the same meaning as total services costs in §1.482-9(j).

(ii) Qualified derivative payments. Any qualified derivative payment as described in §1.59A-6.

(iii) Effectively connected income--(A) In general. Amounts paid or accrued to a foreign related party that are subject to federal income taxation as income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or regulations. This paragraph (b)(3)(iii) applies only if the taxpayer receives a withholding certificate on which the foreign related party claims an exemption from withholding under section 1441 or 1442 because the amounts are effectively connected income.

(B) Application to certain treaty residents. Notwithstanding paragraph (b)(3)(iii)(A) of this section, if a foreign related party determines its net taxable income under an applicable income tax treaty, amounts paid or accrued to the foreign related party taken into account in determining its net taxable income.

(iv) Exchange loss on a section 988 transaction. Any exchange loss within the meaning of §1.988-2 from a section 988 transaction described in §1.988-1(a)(1) that is an allowable deduction and that results from a payment or accrual by the taxpayer to a foreign related party of the taxpayer.

(v) Amounts paid or accrued with respect to TLAC securities--(A) In general. Except as provided in paragraph (b)(3)(v)(B) of this section, amounts paid or accrued to foreign related parties with respect to TLAC securities.

(B) Limitation on exclusion for TLAC securities. The amount excluded under paragraph (b)(3)(v)(A) of this section is no greater than the product of the scaling ratio and amounts paid or accrued to foreign related parties with respect to TLAC securities for which a deduction is allowed.

(C) Scaling ratio. For purposes of this paragraph (b)(3)(v), the scaling ratio for a taxable year of a taxpayer is a fraction the numerator of which is the average TLAC long-term debt required amount and the denominator of which is the average TLAC securities amount. The scaling ratio may in no event be greater than one.

(D) Average TLAC securities amount. The average TLAC securities amount for a taxable year is the average of the TLAC securities amounts for the year, computed at regular time intervals in accordance with this paragraph. The TLAC securities amounts used in calculating the average TLAC securities amount is computed on a monthly basis.

(E) Average TLAC long-term debt required amount. The average TLAC long-term debt required amount for a taxable year is the average of the TLAC long-term debt required amounts, computed on a monthly basis.

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

(vii) Business interest carried forward from taxable years beginning before January 1, 2018. Any disallowed business interest described in section 163(j)(2) that is carried forward from a taxable year beginning before January 1, 2018.

(4) Rules for determining the amount of certain base erosion payments. The following rules apply in determining the deductible amount that is a base erosion payment.

(i) Interest expense allocable to a foreign corporation's effectively connected income--(A) Method described in §1.882-5(b) through (d). A foreign corporation that has interest expense allocable under section 882(c) to income that is, or is treated as, effectively connected with the conduct of a trade or business within the United States applying the method described in §1.882-5(b) through (d) has base erosion payments under paragraph (b)(1)(i) of this section for the taxable year equal to the sum of--

(1) The interest expense on a liability described in §1.882-5(a)(1)(ii)(A) or (B) (direct allocations) or interest expense on U.S.-booked liabilities, as described in §1.882-5(d)(2), that is paid or accrued by the foreign corporation to a foreign related party; and

(2) The interest expense on U.S.-connected liabilities in excess of U.S.-booked liabilities (hereafter, excess U.S.-connected liabilities), as described in §1.882-5(d)(5), multiplied by a fraction, the numerator of which is the foreign corporation's average worldwide liabilities due to a foreign related party, and the denominator of which is the foreign corporation's average total worldwide liabilities. For purposes of this fraction, any liability that is a U.S.-booked liability or is subject to a direct allocation is excluded from both the numerator and the denominator of the fraction.

(B) Separate currency pools method. A foreign corporation that has interest expense allocable under section 882(c) to income that is, or is treated as, effectively connected with the conduct of a trade or business within the United States applying the separate currency pools method described in §1.882-5(e) has a base erosion payment under paragraph (b)(1)(i) of this section for the taxable year equal to the sum of—

(1) The interest expense on a liability described in §1.882-5(a)(1)(ii)(A) or (B) (direct allocations) that is paid or accrued by the foreign corporation to a foreign related party; and

(2) The interest expense attributable to each currency pool, as described in §1.882-5(e)(1)(iii), multiplied by a fraction equal to the foreign corporation's average worldwide liabilities denominated in that currency and that is due to a foreign related party over the foreign corporation's average total worldwide liabilities denominated in that currency. For purposes of this fraction, any liability that has a direct allocation is excluded from both the numerator and the denominator.

(C) U.S.-booked liabilities in excess of U.S.-connected liabilities. A foreign corporation that is computing its interest expense under the method described in §1.882-5(b) through (d) and that has U.S.-booked liabilities in excess of U.S.-connected liabilities must apply the scaling ratio pro-rata to all interest expense consistent with §1.882-5(d)(4) for purposes of determining the amount of allocable interest expense that is a base erosion payment.

(D) Liability reduction election. A foreign corporation that elects to reduce its liabilities under §1.884-1(e)(3) must reduce its liabilities on a pro-rata basis, consistent with the requirements under §1.884-1(e)(3)(iii), for purposes of determining the amount of allocable interest expense that is a base erosion payment.

(ii) Other deductions allowed with respect to effectively connected income. A deduction allowed under §1.882-4 for an amount paid or accrued by the foreign corporation to a foreign related party (including a deduction for an amount apportioned in part to effectively connected income and in part to income that is not effectively connected income) is treated as a base erosion payment under paragraph (b)(1) of this section.

(iii) Depreciable property. Any amount paid or accrued by the foreign corporation to a foreign related party of the taxpayer in connection with the acquisition of property by the foreign corporation from the foreign related party if the character of the property is subject to the allowance for depreciation (or amortization in lieu of depreciation) is a base erosion payment to the extent the property so acquired is used, or held for use, in the conduct of a trade or business within the United States.

(iv) Coordination with ECI exception. For purposes of this paragraph (b)(4), amounts paid or accrued to a foreign related party treated as effectively connected income (or, in the case of foreign related party that determines net taxable income under an applicable income tax treaty, such amounts that are taken into account in determining net taxable income) are not treated as paid to a foreign related party. Additionally, for purposes of paragraph (b)(4)(i)(A)(2) or (b)(4)(i)(B)(2) of this section, a liability with interest paid or accrued to a foreign related party that is treated as effectively connected income (or, in the case of foreign related party that determines net taxable income under an applicable income tax treaty, interest taken into account in determining net taxable income) is treated as a liability not due to a foreign related party.

(v) Coordination with certain tax treaties--(A) Allocable expenses. If a foreign corporation elects to determine its taxable income pursuant to business profits provisions of an income tax treaty rather than provisions of the Internal Revenue Code, or the regulations published under 26 CFR chapter I, for determining effectively connected income, and the foreign corporation does not apply §§1.882-5 and 1.861-8 to allocate interest and other deductions, then in applying paragraphs (b)(4)(i) and (ii) of this section, the foreign corporation must determine whether each allowable deduction attributed to the permanent establishment in its determination of business profits is a base erosion payment under paragraph (b)(1) of this section.

(B) Internal dealings under certain income tax treaties. If, pursuant to the terms of an applicable income tax treaty, a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed, and functions performed by the permanent establishment, then any deduction attributable to any amount paid or accrued (or treated as paid or accrued) by the permanent establishment to the foreign corporation's home office or to another branch of the foreign corporation (an "internal dealing") is a base erosion payment to the extent such payment or accrual is described under paragraph (b)(1) of this section.

(vi) Business interest expense arising in taxable years beginning after December 31, 2017. Any disallowed business interest expense described in section 163(j)(2) that resulted from a payment or accrual to a foreign related party that first arose in a taxable year beginning after December 31, 2017, is treated as a base erosion payment under paragraph (b)(1)(i) of this section in the year that the business interest expense initially arose. See paragraph (c)(4) of this section for rules that apply when business interest expense is limited under section 163(j)(1) in order to determine whether the disallowed business interest is attributed to business interest expense paid to a person that is not a related party, a foreign related party, or a domestic related party.

(c) Base erosion tax benefit--(1) In general. Except as provided in paragraph (c)(2) of this section, a base erosion tax benefit means:

(i) In the case of a base erosion payment described in paragraph (b)(1)(i) of this section, any deduction that is allowed under chapter 1 of subtitle A of the Internal Revenue Code for the taxable year with respect to that base erosion payment;

(ii) In the case of a base erosion payment described in paragraph (b)(1)(ii) of this section, any deduction allowed under chapter 1 of subtitle A of the Internal Revenue Code for the taxable year for depreciation (or amortization in lieu of depreciation) with respect to the property acquired with that payment;

(iii) In the case of a base erosion payment described in paragraph (b)(1)(iii) of this section, any reduction under section 803(a)(1)(B) in the gross amount of premiums and other consideration on insurance and annuity contracts for premiums and other consideration arising out of indemnity insurance, or any deduction under section 832(b)(4)(A) from the amount of gross premiums written on insurance contracts during the taxable year for premiums paid for reinsurance; or

(iv) In the case of a base erosion payment described in paragraph (b)(1)(iv) of this section, any reduction in gross receipts with respect to the payment in computing gross income of the taxpayer for the taxable year for purposes of chapter 1 of subtitle A of the Internal Revenue Code.

(2) Withholding tax exception to base erosion tax benefit. Except as provided in paragraph (c)(3) of this section, any base erosion tax benefit attributable to any base erosion payment is not taken into account as a base erosion tax benefit if tax is imposed on that payment under section 871 or 881, and the tax has been deducted and withheld under section 1441 or 1442.

(3) Effect of treaty on base erosion tax benefit. If any treaty between the United States and any foreign country reduces the rate of tax imposed by section 871 or 881, the amount of base erosion tax benefit that is not taken into account under paragraph (c)(2) of this section is equal to the amount of the base erosion tax benefit before the application of paragraph (c)(2) of this section multiplied by a fraction of—

(i) The rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty; over

(ii) The rate of tax imposed without regard to the treaty.

(4) Application of section 163(j) to base erosion payments--(i) Classification of payments or accruals of business interest expense based on the payee. The following rules apply for corporations and partnerships:

(A) Classification of payments or accruals of business interest expense of a corporation. For purposes of this section, in the year that business interest expense of a corporation is paid or accrued the business interest expense is classified as foreign related business interest expense, domestic related business interest expense, or unrelated business interest expense.

(B) Classification of payments or accruals of business interest expense by a partnership. For purposes of this section, in the year that business interest expense of a partnership is paid or accrued, the business interest expense that is allocated to a partner is classified separately with respect to each partner in the partnership as foreign related business interest expense, domestic related business interest expense, or unrelated business interest expense.

(C) Classification of payments or accruals of business interest expense that is subject to the exception for effectively connected income. For purposes of paragraph (c)(4)(i)(A) and (B) of this section, business interest expense paid or accrued to a foreign related party to which the exception in paragraph (b)(3)(iii) of this section (effectively connected income) applies is classified as domestic related business interest expense.

(ii) Ordering rules for business interest expense that is limited under section 163(j)(1) to determine which classifications of business interest expense are deducted and which classifications of business interest expense are carried forward--(A) In general. Section 163(j) and the regulations published under 26 CFR chapter I provide a limitation on the amount of business interest expense allowed as a deduction in a taxable year by a corporation or a partner in a partnership. In the case of a corporation with a disallowed business interest expense carryforward, the regulations under section 163(j) determine the ordering of the business interest expense deduction that is allowed on a year-by-year basis by reference first to business interest expense incurred in the current taxable year and then to disallowed business interest expense carryforwards from prior years. To determine the amount of base erosion tax benefit under paragraph (c)(1) of this section, this paragraph (c)(4)(ii) sets forth ordering rules that determine the amount of the deduction of business interest expense allowed under section 163(j) that is classified as paid or accrued to a foreign related party for purposes of paragraph (c)(1)(i) of this section. This paragraph (c)(4)(ii) also sets forth similar ordering rules that apply to disallowed business interest expense carryforwards for which a deduction is permitted under section 163(j) in a later year.

(B) Ordering rules for treating business interest expense deduction and disallowed business interest expense carryforwards as foreign related business interest expense, domestic related business interest expense, and unrelated business interest expense--(1) General ordering rule for allocating business interest expense deduction between classifications. For purposes of paragraph (c)(1) of this section, if a deduction for business interest expense is not subject to the limitation under section 163(j)(1) in a taxable year, the deduction is treated first as foreign related business interest expense and domestic related business interest expense (on a pro-rata basis), and second as unrelated business interest expense. The same principle applies to business interest expense of a partnership that is deductible at the partner level under §1.163(j)-6(f).

(2) Ordering of business interest expense incurred by a corporation. If a corporation's business interest expense deduction allowed for any taxable year is attributable to business interest expense paid or accrued in that taxable year and to disallowed business interest expense carryforwards from prior taxable years, the ordering of business interest expense deduction provided in paragraph (c)(4)(ii)(B)(1) of this section among the classifications described therein applies separately for the carryforward amount from each taxable year, following the ordering set forth in §1.163(j)-5(b)(2). Corresponding adjustments to the classification of disallowed business interest expense carryforwards are made consistent with this year-by-year approach. For purposes of section 59A and this section, an acquiring corporation in a transaction described in section 381(a) will succeed to and take into account the classification of any disallowed business interest expense carryforward. See §1.381(c)(20)-1.

(3) Ordering of business interest expense incurred by a partnership and allocated to a corporate partner. For a corporate partner in a partnership that is allocated a business interest expense deduction under §1.163(j)-6(f), the ordering rule provided in paragraph (c)(4)(ii)(B)(1) of this section applies separately to the corporate partner's allocated business interest expense deduction from the partnership; that deduction is not comingled with the business interest expense deduction addressed in paragraph (c)(4)(ii)(B)(1) or (2) of this section or the corporate partner's items from any other partnership. Similarly, when a corporate partner in a partnership is allocated excess

business interest expense from a partnership under the rules set forth in §1.163(j)-6(f) and the excess interest expense becomes deductible to the corporate partner, that partner applies the ordering rule provided in paragraph (c)(4)(ii)(B)(1) of this section separately to that excess interest expense on a year-by-year basis. Corresponding adjustments to the classification of disallowed business interest expense carryforwards are made consistent with this year-by-year and partnership-by-partnership approach.

(d) Examples. The following examples illustrate the application of this section. For purposes of all the examples, assume that the taxpayer is an applicable taxpayer and all payments apply to a taxable year beginning after December 31, 2017.

(1) Example 1: Determining a base erosion payment. (i) Facts. FP is a foreign corporation that owns all of the stock of FC, a foreign corporation, and DC, a domestic corporation. FP has a trade or business in the United States with effectively connected income (USTB). DC owns FDE, a foreign disregarded entity. DC pays interest to FDE and FC. FDE pays interest to USTB. All interest paid by DC to FC and by FDE to USTB is deductible by DC in the current year for regular income tax purposes. FDE also acquires depreciable property from FP during the taxable year. FP's income from the sale of the depreciable property is not effectively connected with the conduct of FP's trade or business in the United States. DC and FP (based only on the activities of USTB) are applicable taxpayers under §1.59A-2(b).

(ii) Analysis. The payment of interest by DC to FC is a base erosion payment under paragraph (b)(1)(i) of this section because the payment is made to a foreign related party and the interest payment is deductible. The payment of interest by DC to FDE is not a base erosion payment because the transaction is not a payment to a foreign person and the transaction is not a deductible payment. With respect to the payment of interest by FDE to USTB, if FP's USTB treats the payment of interest by FDE to USTB as income that is effectively connected with the conduct of a trade or business in the United States pursuant to section 864 or as profits attributable to a U.S. permanent establishment of a tax treaty resident, and if DC receives a withholding certificate from FP with respect to the payment, then the exception in paragraph (b)(3)(iii) of this section applies. Accordingly, the payment from DC, through FDE, to USTB is not a base erosion payment even though the payment is to the USTB of FP, a foreign related party. The acquisition of depreciable property by DC, through FDE, is a base erosion payment under paragraph (b)(1)(ii) of this section because there is a payment to a foreign related party in connection with the acquisition by the taxpayer of property of a character subject to the allowance for depreciation and the exception in paragraph (b)(3)(iii) of this section does not apply because FP's income from the sale of the depreciable property is not effectively connected with the conduct of FP's trade or business in the United States. See §1.59A-2 for the application of the aggregation rule with respect to DC and FP's USTB.

(2) Example 2: Interest allocable under §1.882-5. (i) Facts. FC, a foreign corporation, has income that is effectively connected with the conduct of a trade or business within the United States. FC determines its interest expense under the three-step process described in §§1.882-5(b) through (d) with a total interest expense of $125x. The total interest expense is comprised of interest expense of $100x on U.S.-booked liabilities ($60x paid to a foreign related party and $40x paid to unrelated persons) and $25x of interest on excess U.S.-connected liabilities. FC has average total liabilities (that are not U.S.-booked liabilities) of $10,000x and of that number $2000x are liabilities held by a foreign related party. FC is an applicable taxpayer with respect to its effectively connected income. Assume all of the interest expense is deductible in the current taxable year and that none of the interest is subject to the effectively connected income exception in paragraph (b)(3)(iii) of this section.

(ii) Analysis. Under paragraph (b)(4)(i) of this section, the total amount of interest expense determined under §1.882-5 that is a base erosion payment is $65x ($60x + 5x). FC has $60x of interest on U.S.-booked liabilities that is paid to a foreign related party and that is treated as a base erosion payment under paragraph (b)(4)(i)(A)(1) of this section. Additionally, $5x of the $25x of interest on excess U.S.-connected liabilities is treated as a base erosion payment under paragraph (b)(4)(i)(A)(2) of this section ($25x * ($2000x / $10,000x)).

(3) Example 3: Interaction with section 163(j). (i) Facts. Foreign Parent (FP) is a foreign corporation that owns all of the stock of DC, a domestic corporation that is an applicable taxpayer. In Year 1, DC has adjusted taxable income, as defined in section 163(j)(8), of $1000x and pays the following amounts of business interest expense: $420x that is paid to unrelated Bank, and $360x that is paid to FP. DC does not earn any business interest income or incur any floor plan financing interest expense in Year 1. None of the exceptions in paragraph (b)(3) of this section apply, and the interest is not subject to withholding.

(ii) Analysis—(A) Classification of business interest. In Year 1, DC is only permitted to deduct $300x of business interest expense under section 163(j)(1) ($1000x x 30%). Paragraph (c)(4)(ii)(B) of this section provides that for purposes of paragraph (c)(1) of this section the deduction is treated first as foreign related business interest expense and domestic related business interest expense (here, only FP); and second as unrelated business interest expense (Bank). As a result, the $300x of business interest expense that is permitted under section 163(j)(1) is treated entirely as the business interest paid to the related foreign party, FP. All of DC's $300x deductible interest is treated as an add-back to modified taxable income in the Year 1 taxable year for purposes of §1.59A-4(b)(2)(i).

(B) Ordering rules for business interest expense carryforward. Under section 163(j)(2), the $480x of disallowed business interest ($420x + $360x - $300x) is carried forward to the subsequent year. Under paragraph (c)(4)(ii)(B)(1) and (2) of this section, the interest carryforward is correspondingly treated first as unrelated business interest expense, and second pro-rata as foreign related business interest expense and domestic related business interest expense. As a result, $420x of the $480x business interest expense carryforward is treated first as business interest expense paid to Bank and the remaining $60x of the $480x business interest expense carryforward is treated as interest paid to FP and as an add-back to modified taxable income.

(4) Example 4: Interaction with section 163(j); carryforward. (i) Facts. The facts are the same as in paragraph (d)(3) of this section (the facts in Example 3), except that in addition, in Year 2, DC has adjusted taxable income of $250x, and pays the following amounts of business interest expense: $50x that is paid to unrelated Bank, and $45x that is paid to FP. DC does not earn any business interest income or incur any floor plan financing interest expense in Year 2. None of the exceptions in paragraph (b)(3) of this section apply.

(ii) Analysis—(A) Classification of business interest. In Year 2, for purposes of section 163(j)(1), DC is treated as having paid or accrued total business interest of $575x, consisting of $95x business interest expense actually paid in Year 2 and $480x of business interest expense that is carried forward from Year 1. DC is permitted to deduct $75x of business interest expense in Year 2 under the limitation in section 163(j)(1) ($250x x 30%). Section 1.163(j)-5(b)(2) provides that, for purposes of section 163(j), the allowable business interest expense is first attributed to amounts paid or accrued in the current year, and then attributed to amounts carried over from earlier years on a first-in-first-out basis from the earliest year. Accordingly, the $75x of deductible business interest expense is deducted entirely from the $95x business interest expense incurred in Year 2 for section 163(j) purposes. Because DC's business interest expense deduction is limited under section 163(j)(1) and because DC's total business interest expense is attributable to more than one taxable year, paragraph (c)(4)(ii)(B)(2) of this section provides that the ordering rule in paragraph (c)(4)(ii)(B)(1) of this section is applied separately to each annual amount of section 163(j) disallowed business interest expense carryforward. With respect to the Year 2 layer, which is deducted first, paragraph (c)(4)(ii)(B) of this section provides that, for purposes of paragraph (c)(1) of this section, the Year 2 $75x deduction is treated first as foreign related business interest expense and domestic related business interest expense (here, only FP, $45x); and second as unrelated business interest expense (Bank, $30x). Consequentially, all of the $45x deduction of business interest expense that was paid to FP in Year 2 is treated as a base erosion tax benefit and an add-back to modified taxable income for the Year 2 taxable year for purposes of §1.59A-4(b)(2)(i).

(B) Ordering rules for business interest expense carryforward. The disallowed business interest expense carryforward of $20x from Year 2 is correspondingly treated first as interest paid to Bank under paragraph (c)(4)(i) of this section. The disallowed business interest expense carryforward of $480x from the Year 1 layer that is also not allowed as a deduction in Year 2 remains treated as $420x paid to Bank and $60 paid to FP.

(5) Example 5: Interaction with section 163(j); carryforward. (i) Facts. The facts are the same as in paragraph (d)(4) of this section (the facts in Example 4), except that in addition, in Year 3, DC has adjusted taxable income of $4000x and pays no business interest expense. DC does not earn any business interest income or incur any floor plan financing interest expense in Year 3.

(ii) Analysis. In Year 3, DC is treated as having paid or accrued total business interest expense of $500x, consisting of $480x of business interest expense that is carried forward from Year 1 and $20x of business interest expense that is carried forward from Year 2 for purposes of section 163(j)(1). DC is permitted to deduct $1200x of business interest expense in Year 3 under the limitation in section 163(j)(1) ($4000x x 30%). For purposes of section 163(j), DC is treated as first deducting the business interest expense from Year 1 then the business interest expense from Year 2. See §1.163(j)-5(b)(2). Because none of DC's $500x business interest expense is limited under section 163(j), the stacking rule in paragraph (c)(4)(ii) of this section for allowed and disallowed business interest expense does not apply. For purposes of §1.59A-4(b)(2)(i), DC's add-back to modified taxable income is $60x determined by the classifications in paragraph (c)(4)(i)(A) of this section ($60x treated as paid to FP from Year 1).

(6) Example 6: Interaction with section 163(j); partnership. (i) Facts. The facts are the same as in paragraph (d)(4) of this section (the facts in Example 4), except that in addition, in Year 2, DC forms a domestic partnership (PRS) with Y, a domestic corporation that is not related to DC within the meaning of §1.59A-1(b)(17). DC and Y

are equal partners in partnership PRS. In Year 2, PRS has ATI of $100x and $48x of business interest expense. $12x of PRS's business interest expense is paid to Bank, and $36x of PRS's business interest expense is paid to FP. PRS allocates the items comprising its $100x of ATI $50x to DC and $50x to Y. PRS allocates its $48x of business interest expense $24x to DC and $24x to Y. DC classifies its $24x of business interest expense as $6x unrelated business interest expense (Bank) and $18x as foreign related business interest expense (FP) under paragraph (c)(4)(i)(B) of this section. Y classifies its $24x of business interest expense as entirely unrelated business interest expense of Y (Bank and FP) under paragraph (c)(4)(i)(B) of this section. None of the exceptions in paragraph (b)(3) of this section apply.

(ii) Partnership level analysis. In Year 2, PRS's section 163(j) limit is 30 percent of its ATI, or $30x ($100x x 30 percent). Thus, PRS has $30x of deductible business interest expense and $18x of excess business interest expense ($48x - $30x). The $30x of deductible business interest expense is includible in PRS's non-separately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) Partner level allocations analysis. Pursuant to §1.163(j)-6(f)(2), DC and Y are each allocated $15x of deductible business interest expense and $9x of excess business interest expense. At the end of Year 2, DC and Y each have $9x of excess business interest expense from PRS, which under §1.163(j)-6 is not treated as paid or accrued by the partner until such partner is allocated excess taxable income or excess business interest income from PRS in a succeeding year. Pursuant to §1.163(j)-6(e), DC and Y, in computing their limit under section 163(j), do not increase any of their section 163(j) items by any of PRS's section 163(j) items.

(iv) Partner level allocations for determining base erosion tax benefits. The $15x of deductible business interest expense allocated to DC is treated first as foreign related business interest expense (FP) under paragraph (c)(4)(ii)(B) of this section. DC's excess business interest expense from PRS of $9x is classified first as the unrelated business interest expense with respect to Bank ($6x) and then as the remaining portion of the business interest expense paid to FP ($3x, or $18x - $15x). Under paragraph (c)(4)(ii)(B)(3) of this section, these classifications of the PRS items apply irrespective of the classifications of DC's own interest expense as set forth in paragraph (d)(4) of this section (Example 4).

(v) Computation of modified taxable income. For Year 2, DC is treated as having incurred base erosion tax benefits of $60x, consisting of the $15x base erosion tax benefit with respect to its interest in PRS that is computed in paragraph (d)(6)(iii) of this section (Example 6) and $45x that is computed in paragraph (d)(4) of this section

(Example 4).

(7) Example 7: Transfers of property to related taxpayers. (i) Facts. FP is a foreign corporation that owns all of the stock of DC1 and DC2, both domestic corporations. DC1 and DC2 are both members of the same aggregate group but are not members of the same consolidated tax group under section 1502. In Year 1, FP sells depreciable property to DC1. On the first day of the Year 2 tax year, DC1 sells the depreciable property to DC2.

(ii) Analysis—(A) Year 1. The acquisition of depreciable property by DC1 from FP is a base erosion payment under paragraph (b)(1)(ii) of this section because there is a payment to a foreign related party in connection with the acquisition by the taxpayer of property of a character subject to the allowance for depreciation.

(B) Year 2. The acquisition of the depreciable property in Year 2 by DC2 is not itself a base erosion payment because DC2 did not acquire the property from a foreign related party. However, under paragraph (b)(2)(vi) of this section any depreciation expense taken by DC2 on the property acquired from DC1 is a base erosion payment and a base erosion tax benefit under paragraph (c)(1)(ii) of this section because the acquisition of the depreciable property was a base erosion payment by DC1 and the property was sold to a member of the aggregate group; therefore, the depreciation expense continues as a base erosion tax benefit to DC2 as it would have been to DC1 if it continued to own the property.

§1.59A-4 Modified taxable income.

(a) Scope. Paragraph (b)(1) of this section provides rules for computing modified taxable income. Paragraph (b)(2) of this section provides rules addressing how base erosion tax benefits and net operating losses affect modified taxable income. Paragraph (b)(3) of this section provides a rule for a holder of a residual interest in a REMIC. Paragraph (c) of this section provides examples illustrating the rules described in this section.

(b) Computation of modified taxable income--(1) In general. The term modified taxable income means a taxpayer's taxable income, as defined in section 63(a), determined with the additions described in paragraph (b)(2) of this section. Notwithstanding the foregoing, the taxpayer's taxable income may not be reduced to an amount less than zero as a result of a net operating loss deduction allowed under section 172. See paragraphs (c)(1) and (2) of this section (Examples 1 and 2).

(2) Modifications to taxable income. The amounts described in this paragraph (b)(2) are added back to a taxpayer's taxable income to determine its modified taxable income.

(i) Base erosion tax benefits. The amount of any base erosion tax benefit as defined in §1.59A-3(c)(1).

(ii) Certain net operating loss deductions. The base erosion percentage, as described in §1.59A-2(e)(3), of any net operating loss deduction allowed to the taxpayer under section 172 for the taxable year. For purposes of determining modified taxable income, the net operating loss deduction allowed does not exceed taxable income before taking into account the net operating loss deduction. See paragraph (c)(1) and (2) of this section (Examples 1 and 2). The base erosion percentage for the taxable year that the net operating loss arose is used to determine the addition under this paragraph (b)(2)(ii). For a net operating loss that arose in a taxable year beginning before January 1, 2018, the base erosion percentage for the taxable year is zero.

(3) Rule for holders of a residual interest in a REMIC. For purposes of paragraph (b)(1) of this section, the limitation in section 860E(a)(1) is not taken into account for

determining the taxable income amount that is used to compute modified taxable income for the taxable year.

(c) Examples. The following examples illustrate the rules of paragraph (b) of this section.

(1) Example 1: Current year loss. (i) Facts. A domestic corporation (DC) is an applicable taxpayer that has a calendar taxable year. In 2020, DC has gross income of $100x, a deduction of $80x that is not a base erosion tax benefit, and a deduction of $70x that is a base erosion tax benefit. In addition, DC has a net operating loss carryforward to 2020 of $400x that arose in 2016.

(ii) Analysis. DC's starting point for computing modified taxable income is $(50x), computed as gross income of $100x, less a deduction of $80x (non-base erosion tax benefit) and a deduction of $70x (base erosion tax benefit). Under paragraph (b)(2)(ii) of this section, DC's starting point for computing modified taxable income does not take into account the $400x net operating loss carryforward because the allowable deductions for 2020, not counting the NOL deduction, exceed the gross income for 2020. DC's modified taxable income for 2020 is $20x, computed as $(50x) + $70x base erosion tax benefit.

(2) Example 2: Net operating loss deduction. (i) Facts. The facts are the same as in paragraph (c)(1)(i) of this section (the facts in Example 1), except that DC's gross income in 2020 is $500x.

(ii) Analysis. DC's starting point for computing modified taxable income is $0x, computed as gross income of $500x, less: a deduction of $80x (non-base erosion tax benefit), a deduction of $70x (base erosion tax benefit), and a net operating loss deduction of $350x (which is the amount of taxable income before taking into account the net operating loss deduction, as provided in paragraph (b)(2)(ii) of this section ($500x - $150x)). DC's modified taxable income for 2020 is $70x, computed as $0x + $70x base erosion tax benefit. DC's modified taxable income is not increased as a result of the $350x net operating loss deduction in 2020 because the base erosion percentage of the net operating loss that arose in 2016 is zero under paragraph (b)(2)(ii) of this section.

§1.59A-5 Base erosion minimum tax amount.

(a) Scope. Paragraph (b) of this section provides rules regarding the calculation of the base erosion minimum tax amount. Paragraph (c) of this section describes the base erosion and anti-abuse tax rate applicable to the taxable year.

(b) In general. With respect to any applicable taxpayer, the base erosion minimum tax amount for any taxable year is, the excess (if any) of--

(1) An amount equal to the base erosion and anti-abuse tax rate multiplied by the modified taxable income of the taxpayer for the taxable year, over

(2) An amount equal to the regular tax liability as defined in §1.59A-1(b)(16) of the taxpayer for the taxable year, reduced (but not below zero) by the excess (if any) of-

(i) The credits allowed under chapter 1 of subtitle A of the Code against regular tax liability over

(ii) The sum of the credits described in paragraph (b)(3) of this section.

(3) Credits that do not reduce regular tax liability. The sum of the following credits are used in paragraph (b)(2)(ii) of this section to limit the amount by which the credits allowed under chapter 1 of subtitle A of the Internal Revenue Code reduce regular tax liability—

(i) Taxable years beginning on or before December 31, 2025. For any taxable year beginning on or before December 31, 2025--

(A) The credit allowed under section 38 for the taxable year that is properly allocable to the research credit determined under section 41(a);

(B) The portion of the applicable section 38 credits not in excess of 80 percent of the lesser of the amount of those applicable section 38 credits or the base erosion minimum tax amount (determined without regard to this paragraph (b)(3)(i)(B)); and

(C) Any credits allowed under sections 33 and 37.

(ii) Taxable years beginning after December 31, 2025. For any taxable year beginning after December 31, 2025, any credits allowed under sections 33 and 37.

(c) Base erosion and anti-abuse tax rate--(1) In general. For purposes of calculating the base erosion minimum tax amount, the base erosion and anti-abuse tax rate is--

(i) Calendar year 2018. For taxable years beginning in calendar year 2018, five percent.

(ii) Calendar years 2019 through 2025. For taxable years beginning after December 31, 2018, through taxable years beginning before January 1, 2026, 10 percent.

(iii) Calendar years after 2025. For taxable years beginning after December 31, 2025, 12.5 percent.

(2) Increased rate for banks and registered securities dealers. In the case of a taxpayer that is a member of an affiliated group (as defined in section 1504(a)(1)) that includes a bank or a registered securities dealer, the percentage otherwise in effect under paragraph (c)(1) of this section is increased by one percentage point.

(3) Application of section 15. Section 15 does not apply to any taxable year that includes January 1, 2018. See §1.15-1(d). For a taxpayer using a taxable year other than the calendar year, section 15 applies to any taxable year beginning after January 1, 2018.

§1.59A-6 Qualified derivative payment.

(a) Scope. This section provides additional guidance regarding qualified derivative payments. Paragraph (b) of this section defines the term qualified derivative payment. Paragraph (c) of this section provides guidance on certain payments that are not treated as qualified derivative payments. Paragraph (d) defines the term derivative for purposes of section 59A. Paragraph (e) of this section provides an example illustrating the rules of this section.

(b) Qualified derivative payment--(1) In general. A qualified derivative payment means any payment made by a taxpayer to a foreign related party pursuant to a derivative with respect to which the taxpayer--

(i) Recognizes gain or loss as if the derivative were sold for its fair market value on the last business day of the taxable year (and any additional times as required by the Internal Revenue Code or the taxpayer’s method of accounting);

(ii) Treats any gain or loss so recognized as ordinary; and

(iii) Treats the character of all items of income, deduction, gain, or loss with respect to a payment pursuant to the derivative as ordinary.

(2) Reporting requirements--(i) In general. No payment is a qualified derivative payment under paragraph (b)(1) of this section for any taxable year unless the taxpayer reports the information required in §1.6038A-2(b)(7)(ix) for the taxable year.

(ii) Failure to satisfy the reporting requirement. If a taxpayer fails to satisfy the reporting requirement described in paragraph (b)(2)(i) of this section with respect to any payments, those payments will not be eligible for the qualified derivative payment exception described in §1.59A-3(b)(3)(ii). A taxpayer's failure to report a payment as a qualified derivative payment does not impact the eligibility of any other payment which the taxpayer properly reported under paragraph (b)(2)(i) of this section from being a qualified derivative payment.

(3) Amount of any qualified derivative payment. The amount of any qualified derivative payment excluded from the denominator of the base erosion percentage as provided in §1.59A-2(e)(3)(ii)(C) is determined as provided in §1.59A-2(e)(3)(vi).

(c) Exceptions for payments otherwise treated as base erosion payments. A payment does not constitute a qualified derivative payment if—

(1) The payment would be treated as a base erosion payment if it were not made pursuant to a derivative, including any interest, royalty, or service payment; or

(2) In the case of a contract that has derivative and nonderivative components, the payment is properly allocable to the nonderivative component.

(d) Derivative defined--(1) In general. For purposes of this section, the term derivative means any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

(i) Any share of stock in a corporation;

(ii) Any evidence of indebtedness;

(iii) Any commodity that is actively traded;

(iv) Any currency; or

(v) Any rate, price, amount, index, formula, or algorithm.

(2) Exceptions. The following contracts are not treated as derivatives for purposes of section 59A.

(i) Direct interest. A derivative contract does not include a direct interest in any item described in paragraph (d)(1)(i) through (v) of this section.

(ii) Insurance contracts. A derivative contract does not include any insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or issued by any foreign corporation to which the subchapter would apply if the foreign corporation were a domestic corporation).

(iii) Securities lending and sale-repurchase transactions. A derivative contract does not include any securities lending transaction, sale-repurchase transaction, or substantially similar transaction. Securities lending transaction and sale-repurchase transaction have the same meaning as provided in §1.861-2(a)(7).

(3) American depository receipts. For purposes of section 59A, American depository receipts (or any similar instruments) with respect to shares of stock in a foreign corporation are treated as shares of stock in that foreign corporation.

(e) Example. The following example illustrates the rules of this section.

(1) Facts. Domestic Corporation (DC) is a dealer in securities within the meaning of section 475. On February 1, 2019, DC enters into a contract (Interest Rate Swap) with Foreign Parent (FP), a foreign related party, for a term of five years. Under the Interest Rate Swap, DC is obligated to make a payment to FP each month, beginning March 1, 2019, in an amount equal to a variable rate determined by reference to the prime rate, as determined on the first business day of the immediately preceding month, multiplied by a notional principal amount of $50 million. Under the Interest Rate Swap, FP is obligated to make a payment to DC each month, beginning March 1, 2019, in an amount equal to 5% multiplied by the same notional principal amount. The Interest Rate Swap satisfies the definition of a notional principal contract under §1.446-3(c). DC recognizes gain or loss on the Interest Rate Swap pursuant to section 475. DC reports the information required to be reported for the taxable year under §1.6038A-2(b)(7)(ix).

(2) Analysis. The Interest Rate Swap is a derivative as described in paragraph (d) of this section because it is a contract that references the prime rate and a fixed rate for determining the amount of payments. The exceptions described in paragraph (c) of this section do not apply to the Interest Rate Swap. Because DC recognizes ordinary gain or loss on the Interest Rate Swap pursuant to section 475(d)(3), it satisfies the condition in paragraph (b)(1)(ii) of this section. Because DC satisfies the requirement relating to the information required to be reported under paragraph (b)(2) of this section, any payment to FP with respect to the Interest Rate Swap will be a qualified derivative payment. Therefore, under §1.59A-3(b)(3)(ii), the payments to FP are not base erosion payments.

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

(a) Scope. This section provides rules regarding how partnerships and their partners are treated for purposes of section 59A. Paragraph (b) of this section provides the general application of an aggregate approach to partnerships for purposes of section 59A, including specific rules addressing the application of section 59A to amounts paid or accrued by a partnership to a related party, rules addressing the application of section 59A to amounts paid or accrued to a partnership from a related party, and other operating rules. Paragraph (c) of this section provides rules for determining whether a party is a foreign related party.

(b) Application of section 59A to a partnership--(1) In general. Except as otherwise provided in this section, section 59A is applied at the partner level in the manner described in this section. The provisions of section 59A must be interpreted in a manner consistent with this approach.

(2) Payment made by a partnership. Except as provided in paragraph (b)(4) of this section, for purposes of determining whether a payment or accrual by a partnership is a base erosion payment, any amount paid or accrued by a partnership is treated as paid or accrued by each partner based on the partner's distributive share of items of deduction (or other amounts that could be base erosion tax benefits) with respect to that amount (as determined under section 704).

(3) Payment received by a partnership. For purposes of determining whether a payment or accrual to a partnership is a base erosion payment of the payor, any amount paid or accrued to a partnership is treated as paid or accrued to each partner based on the partner's distributive share of the income or gain with respect to that amount (as determined under section 704).

(4) Exception for base erosion tax benefits of certain partners--(i) In general. For purposes of determining a partner's amount of base erosion tax benefits, a partner does

not take into account its distributive share of any partnership amount of base erosion tax benefits for the taxable year if --

(A) The partner's interest in the partnership represents less than ten percent of the capital and profits of the partnership at all times during the taxable year;

(B) The partner is allocated less than ten percent of each partnership item of income, gain, loss, deduction, and credit for the taxable year; and

(C) The partner's interest in the partnership has a fair market value of less than $25 million on the last day of the partner's taxable year, determined using a reasonable method.

(ii) Attribution. For purposes of paragraph (b)(4)(i) of this section, a partner's interest in a partnership or partnership item is determined by adding the interests of the partner and any related party of the partner (as determined under section 59A), taking into account any interest owned directly, indirectly, or through constructive ownership (applying the section 318 rules as modified by section 59A (except section 318(a)(3)(A) through (C) will also apply so as to consider a United States person as owning stock that is owned by a person who is not a United States person), but excluding any interest to the extent already taken into account).

(5) Other relevant items--(i) In general. For purposes of section 59A, subject to paragraph (b)(4) of this section, each partner is treated as owning its share of the partnership items determined under section 704, including the assets of the partnership, using a reasonable method with respect to the assets. For items that are allocated to

the partners, the partner is treated as owning its distributive share (including of deductions and base erosion tax benefits). For items that are not allocated to the partners, the partner is treated as owning an interest proportionate with the partner's distributive share of partnership income.

(ii) Gross receipts--(A) In general. For purposes of section 59A, each partner in the partnership includes a share of partnership gross receipts in proportion to the partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703.

(B) Foreign corporation. A foreign corporation takes into account a share of gross receipts only with regard to receipts that produce income that is effectively connected with the conduct of a trade or business within the United States. In the case of a foreign corporation that determines its net taxable income under an applicable income tax treaty, the foreign corporation takes into account its share of gross receipts only with regard to such gross receipts that are taken into account in determining its net taxable income.

(iii) Registered securities dealers. If a partnership, or a branch of the partnership, is a registered securities dealer, each partner is treated as a registered securities dealer unless the partner's interest in the registered securities dealer would satisfy the criteria for the exception in paragraph (b)(4) of this section. For purposes of applying the de minimis exception in §1.59A-2(e)(2)(iii), the partner takes into account its distributive share of the relevant partnership items.

(iv) Application of sections 163(j) and 59A(c)(3) to partners of partnerships. See §1.59A-3(c)(4).

(6) Tiered partnerships. If the partner of a partnership is a partnership, then paragraphs (b) and (c) of this section are applied again at the level of the partner, applying this paragraph successively until the partner is not a partnership. Paragraph (b)(4) of this section is only applied at the level where the partner is not itself a partnership.

(c) Foreign related party. With respect to any person that owns an interest in a partnership, the related party determination in section 59A(g) applies at the partner level.

§1.59A-8 Application of base erosion and anti-abuse tax to certain expatriated entities. [Reserved]

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

(a) Scope. This section provides rules for recharacterizing certain transactions according to their substance for purposes of applying section 59A and the section 59A regulations. Paragraph (b) of this section provides specific anti-abuse rules. Paragraph (c) of this section provides examples illustrating the rules of paragraph (b) of this section.

(b) Anti-abuse rules--(1) Transactions involving unrelated persons, conduits, or intermediaries. If a taxpayer pays or accrues an amount to one or more intermediaries (including an intermediary unrelated to the taxpayer) that would have been a base erosion payment if paid or accrued to a foreign related party, and one or more of the intermediaries makes (directly or indirectly) corresponding payments to or for the benefit of a foreign related party as part of a transaction (or series of transactions), plan or arrangement that has as a principal purpose avoiding a base erosion payment (or reducing the amount of a base erosion payment), the role of the intermediary or intermediaries is disregarded as a conduit, or the amount paid or accrued to the intermediary is treated as a base erosion payment, as appropriate.

(2) Transactions to increase the amount of deductions taken into account in the denominator of the base erosion percentage computation. A transaction (or component of a transaction or series of transactions), plan or arrangement that has a principal purpose of increasing the deductions taken into account for purposes of §1.59A-2(e)(3)(i)(B) (the denominator of the base erosion percentage computation) is disregarded for purposes of §1.59A-2(e)(3).

(3) Transactions to avoid the application of rules applicable to banks and registered securities dealers. A transaction (or series of transactions), plan or arrangement that occurs among related parties that has a principal purpose of avoiding the rules applicable to certain banks and registered securities dealers in §1.59A-2(e)(2) (base erosion percentage test for banks and registered securities dealers) or §1.59A-5(c)(2) (increased base erosion and anti-abuse tax rate for banks and registered securities dealers) is not taken into account for purposes of §1.59A-2(e)(2) or §1.59A-5(c)(2).

(c) Examples. The following examples illustrate the application of paragraph (b) of this section. For purposes of all of the examples, assume that FP, a foreign corporation, owns all the stock of DC, a domestic corporation and an applicable taxpayer and that none of the foreign corporations are subject to federal income taxation with respect to income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or regulations thereunder. Also assume that all payments occur in a taxable year beginning after December 31, 2017.

(1) Example 1: Substitution of payments that are not base erosion payments for payments that otherwise would be base erosion payments through a conduit or intermediary. (i) Facts. FP owns Property 1 with a fair market value of $95x, which FP intends to transfer to DC. A payment from DC to FP for Property 1 would be a base erosion payment. Corp A is a domestic corporation that is not a related party with respect to DC. As part of a plan with a principal purpose of avoiding a base erosion payment, FP enters into an arrangement with Corp A to transfer Property 1 to Corp A in exchange for $95x. Pursuant to the same plan, Corp A transfers Property 1 to DC in exchange for $100x. Property 1 is subject to the allowance for depreciation (or amortization in lieu of depreciation) in the hands of DC.

(ii) Analysis. The arrangement between FP, DC, and Corp A is deemed to result in a $95x base erosion payment under paragraph (b)(1) of this section because DC's payment to Corp A would have been a base erosion payment if paid to a foreign related person, and Corp A makes a corresponding payment to FP as part of the series of transactions that has as a principal purpose avoiding a base erosion payment.

(2) Example 2: Alternative transaction to base erosion payment. (i) Facts. The facts are the same as in paragraph (c)(1)(i) of this section (the facts in Example 1), except that DC does not purchase Property 1 from FP or Corp A. Instead, DC purchases Property 2 from Corp B, a domestic corporation that is not a related party with respect to DC and that originally produced or acquired Property 2 for Corp B's own account. Property 2 is substantially similar to Property 1, and DC uses Property 2 in substantially the same manner that DC would have used Property 1.

(ii) Analysis. Paragraph (b)(1) of this section does not apply to the transaction between DC and Corp B because Corp B does not make a corresponding payment to or for the benefit of FP as part of a transaction, plan or arrangement.

(3) Example 3: Alternative financing source. (i) Facts. On Date 1, FP loaned $200x to DC in exchange for Note A. DC pays or accrues interest annually on Note A, and the payment or accrual is a base erosion payment within the meaning of §1.59A-3(b)(1)(i). On Date 2, DC borrows $200x from Bank, a corporation that is not a related party with respect to DC, in exchange for Note B. The terms of Note B are substantially similar to the terms of Note A. DC uses the proceeds from Note B to repay Note A.

(ii) Analysis. Paragraph (b)(1) of this section does not apply to the transaction between DC and Bank because Bank does not make a corresponding payment to or for the benefit of FP as part of the series of transactions.

(4) Example 4: Alternative financing source that is a conduit. (i) Facts. The facts are the same as in paragraph (c)(3)(i) of this section (the facts in Example 3) except that in addition, with a principal purpose of avoiding a base erosion payment, and as part of the same plan or arrangement as the Note B transaction, FP deposits $250x with Bank. The difference between the interest rate paid by Bank to FP on FP's deposit and the interest rate paid by DC to Bank is less than one percentage point. The interest rate charged by Bank to DC would have differed absent the deposit by FP.

(ii) Analysis. The transactions between FP, DC, and Bank are deemed to result in a base erosion payment under paragraph (b)(1) of this section because DC's payment to Bank would have been a base erosion payment if paid to a foreign related person, and Bank makes a corresponding payment to FP as part of the series of transactions that has as a principal purpose avoiding a base erosion payment. See Rev. Rul. 87-89, 1987-2 C.B. 195, Situation 3.

(5) Example 5: Transactions to increase the amount of deductions taken into account in the denominator of the base erosion percentage computation. (i) Facts. With a principal purpose of increasing the deductions taken into account by DC for purposes of §1.59A-2(e)(3)(i)(B), DC enters into a long position with respect to Asset with Financial Institution 1 and simultaneously enters into a short position with respect to Asset with Financial Institution 2. Financial Institution 1 and Financial Institution 2 are not related to DC and are not related to each other.

(ii) Analysis. Paragraph (b)(2) of this section applies and the transactions between DC and Financial Institution 1 and DC and Financial Institution 2. These transactions are not taken into account for purposes of §1.59A-2(e)(3)(i)(B) because the transactions have a principal purpose of increasing the deductions taken into account for purposes of §1.59A-2(e)(3)(i)(B).

§1.59A-10 Applicability date.

Sections 1.59A-1 through 1.59A-9 apply to taxable years beginning after December 31, 2017.

Par. 3. Section 1.383-1 is amended by adding two sentences at the end of paragraph (d)(3)(i) to read as follows:

§1.383-1 Special limitations on certain capital losses and excess credits.

*** * * * ***

(d) * * *

(3) * * *

(i) * * * The application of section 59A is not a limitation contained in subtitle A for purposes of this paragraph (d)(3)(i). Therefore, the treatment of pre-change losses and pre-change credits in the computation of the base erosion minimum tax amount will not affect whether such losses or credits result in absorption of the section 382 limitation and the section 383 credit limitation.

* * * * *

Par. 4. Section 1.1502-2 is revised to read as follows:

§1.1502-2 Computation of tax liability.

(a) Taxes imposed. The tax liability of a group for a consolidated return year is determined by adding together--

(1) The tax imposed by section 11(a) in the amount described in section 11(b) on the consolidated taxable income for the year (reduced by the taxable income of a member described in paragraphs (a)(5) through (8) of this section);

(2) The tax imposed by section 541 on the consolidated undistributed personal holding company income;

(3) If paragraph (a)(2) of this section does not apply, the aggregate of the taxes imposed by section 541 on the separate undistributed personal holding company income of the members which are personal holding companies;

(4) If neither paragraph (a)(2) nor (3) of this section apply, the tax imposed by section 531 on the consolidated accumulated taxable income (see §1.1502–43);

(5) The tax imposed by section 594(a) in lieu of the taxes imposed by section 11 on the taxable income of a life insurance department of the common parent of a group which is a mutual savings bank;

(6) The tax imposed by section 801 on consolidated life insurance company taxable income;

(7) The tax imposed by section 831(a) on consolidated insurance company taxable income of the members which are subject to such tax;

(8) Any increase in tax described in section 1351(d)(1) (relating to recoveries of foreign expropriation losses); and

(9) The tax imposed by section 59A on base erosion payments of taxpayers with substantial gross receipts.

(b) Credits. A group is allowed as a credit against the taxes described in paragraph (a) (except for paragraph (a)(9) of this section) of this section: the general business credit under section 38 (see §1.1502–3), the foreign tax credit under section 27 (see §1.1502–4), and any other applicable credits provided under the Internal Revenue Code. Any increase in tax due to the recapture of a tax credit will be taken into account. See section 59A and the regulations thereunder for credits allowed against the tax described in paragraph (a)(9) of this section.

(c) Allocation of dollar amounts. For purposes of this section, if a member or members of the consolidated group are also members of a controlled group that includes corporations that are not members of the consolidated group, any dollar amount described in any section of the Internal Revenue Code is apportioned among all members of the controlled group in accordance with the provisions of the applicable section and the regulations thereunder.

(d) Applicability date--(1) Except as provided in paragraph (d)(2) of this section, this section applies to any consolidated return year for which the due date of the income tax return (without regard to extensions) is on or after the date of publication of the Treasury Decision adopting these rules as final regulations in the **Federal Register**.

(2) Paragraph (a)(9) of this section applies to consolidated return years beginning after December 31, 2017.

Par. 5. Section 1.1502-4 is amended by revising paragraph (d)(3) to read as follows:

§1.1502-4 Consolidated foreign tax credit.

* * * * *

(d) * * *

(3) Computation of tax against which credit is taken. The tax against which the limiting fraction under section 904(a) is applied will be the consolidated tax liability of the group determined under §1.1502-2, but without regard to paragraphs (a)(2), (3), (4), (8), and (9) of that section, and without regard to any credit against such liability.

* * * * *

Par. 6. Section 1.1502-43 is amended by revising paragraph (b)(2)(i)(A) to read as follows:

§1.1502-43 Consolidated accumulated earnings tax.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(A) The consolidated liability for tax determined without §1.1502-2(a)(2) through (a)(4), and without the foreign tax credit provided by section 27, over

* * * * *

Par. 7. Section 1.1502-47 is amended by revising paragraph (f)(7)(iii) to read as follows.

§1.1502-47 Consolidated returns by life-nonlife groups.

* * * * *

(f) * * *

(7) * * *

(iii) Any taxes described in §1.1502-2 (other than by paragraphs (a)(1) and (d)(6) of that section).

* * * * *

Par. 8. Section 1.1502-59A is added to read as follows:

§1.1502-59A Application of section 59A to consolidated groups.

(a) Scope. This section provides rules for the application of section 59A and the regulations thereunder (the section 59A regulations, see §§1.59A-1 through 1.59A-10) to consolidated groups and their members (as defined in §1.1502-1(h) and (b), respectively). Rules in the section 59A regulations apply to consolidated groups except as modified in this section. Paragraph (b) of this section provides rules treating a consolidated group (rather than each member of the group) as a single taxpayer, and a single applicable taxpayer, as relevant, for certain purposes. Paragraph (c) of this section coordinates the application of the business interest stacking rule under §1.59A-3(c)(4) to consolidated groups. Paragraph (d) of this section addresses how the base erosion minimum tax amount is allocated among members of the consolidated group. Paragraph (e) of this section sets forth definitions. Paragraph (f) of this section provides examples. Paragraph (g) of this section provides the applicability date and a transition rule.

(b) Consolidated group as the applicable taxpayer--(1) In general. For purposes of determining whether the consolidated group is an applicable taxpayer (within the meaning of §1.59A-2(b)) and the amount of tax due pursuant to section 59A(a), all members of a consolidated group are treated as a single taxpayer. Thus, for example, members' deductions are aggregated in making the required computations under section 59A. In addition, items resulting from intercompany transactions (as defined in §1.1502-13(b)(1)(i)) are disregarded for purposes of making the required computations. For example, additional depreciation deductions resulting from intercompany asset sales are not taken into account for purposes of applying the base erosion percentage test under §1.59A-2(e).

(2) Consolidated group as member of the aggregate group. The consolidated group is treated as a single member of an aggregate group for purposes of §1.59A-2(c).

(3) Related party determination. For purposes of section 59A and the section 59A regulations, if a person is a related party with respect to any member of a consolidated group, that person is a related party of the group and of each of its members.

(c) Coordination of section 59A(c)(3) and section 163(j) in a consolidated group--(1) Overview. This paragraph (c) provides rules regarding the application of §1.59A-3(c)(4) to a consolidated group's section 163(j) interest deduction. The classification rule in paragraph (c)(3) of this section addresses how to determine if, and to what extent, the group's section 163(j) interest deduction is a base erosion tax benefit.

These regulations contain a single-entity classification rule with regard to the deduction of the consolidated group's aggregate current year business interest expense ("BIE"), but a separate-entity classification rule for the deduction of the consolidated group's disallowed BIE carryforwards. Paragraph (c)(3) of this section classifies the group's aggregate current year BIE deduction, in conformity with §1.59A-3(c)(4), as constituting domestic related current year BIE deduction, foreign related current year BIE deduction, or unrelated current year BIE deduction. The allocation rules in paragraph (c)(4) of this section then allocate to specific members of the group the domestic related current year BIE deduction, foreign related current year BIE deduction, and unrelated current year BIE deduction taken in the taxable year. Any member's current year BIE that is carried forward to the succeeding taxable year as a disallowed BIE carryforward is allocated a status as domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward under paragraph (c)(5) of this section. The status of any disallowed BIE carryforward deducted by a member in a later year is classified on a separate-entity basis by the deducting member under paragraph (c)(3) of this section, based on the status allocated to the member's disallowed BIE carryforward under paragraph (c)(5) of this section. This paragraph (c) also provides rules regarding the consequences of the deconsolidation of a corporation that has been allocated a domestic related BIE carryforward status, a foreign related BIE carryforward status, or an unrelated BIE carryforward status; and the consolidation of a corporation with a disallowed BIE carryforward classified as from payments to a domestic related party, foreign related party, or unrelated party.

(2) Absorption rule for the group's business interest expense. To determine the amount of the group's section 163(j) interest deduction, and to determine the year in which the member's business interest expense giving rise to the deduction was incurred or accrued, see §§1.163(j)-4(d) and 1.163(j)-5(b)(3).

(3) Classification of the group's section 163(j) interest deduction--(i) In general. Consistent with §1.59A-3(c)(4)(i) and paragraph (b) of this section, the classification rule of this paragraph (c)(3) determines whether the consolidated group's section 163(j) interest deduction is a base erosion tax benefit. To the extent the consolidated group's business interest expense is permitted as a deduction under section 163(j)(1) in a taxable year, the deduction is classified first as from business interest expense paid or accrued to a foreign related party and business interest expense paid or accrued to a domestic related party (on a pro-rata basis); any remaining deduction is treated as from business interest expense paid or accrued to an unrelated party.

(ii) Year-by-year application of the classification rule. If the consolidated group's section 163(j) interest deduction in any taxable year is attributable to business interest expense paid or accrued in more than one taxable year (for example, the group deducts the group's aggregate current year BIE, the group's disallowed BIE carryforward from year 1, and the group's disallowed BIE carryforward from year 2), the classification rule in paragraph (c)(3)(i) of this section applies separately to each of those years, pursuant to paragraphs (c)(3)(iii) and (iv) of this section.

(iii) Classification of current year BIE deductions. Current year BIE deductions are classified under the section 59A regulations and this paragraph (c) as if the consolidated group were a single taxpayer that had paid or accrued the group's aggregate current year BIE to domestic related parties, foreign related parties, and unrelated parties. The rules of paragraph (c)(4) of this section apply for allocating current year BIE deductions among members of the consolidated group. To the extent the consolidated group's aggregate current year BIE exceeds its section 163(j) limitation, the rules of paragraph (c)(5) of this section apply.

(iv) Classification of deductions of disallowed BIE carryforwards. Each member of the group applies the classification rule in this paragraph (c)(3) to its deduction of any part of a disallowed BIE carryforward from a year, after the group applies paragraph (c)(5) of this section to the consolidated group's disallowed BIE carryforward from that year. Therefore, disallowed BIE carryforward that is actually deducted by a member is classified based on the status of the components of that carryforward, assigned pursuant to paragraph (c)(5) of this section.

(4) Allocation of domestic related current year BIE deduction status and foreign related current year BIE deduction status among members of the consolidated group--(i) In general. This paragraph (c)(4) applies if the group has domestic related current year BIE deductions, foreign related current year BIE deductions, or both, as a result of the application of the classification rule in paragraph (c)(3) of this section. Under this paragraph (c)(4), the domestic related current year BIE, foreign related current year

BIE, or both, that is treated as deducted in the current year are deemed to have been incurred pro-rata by all members that have current year BIE deduction in that year, regardless of which member or members actually incurred the current year BIE to a domestic related party or a foreign related party.

(ii) Domestic related current year BIE deduction--(A) Amount of domestic related current year BIE deduction status allocable to a member. The amount of domestic related current year BIE deduction status that is allocated to a member is determined by multiplying the group's domestic related current year BIE deduction (determined pursuant to paragraph (c)(3) of this section) by the percentage of current year BIE deduction allocable to such member in that year.

(B) Percentage of current year BIE deduction allocable to a member. The percentage of current year BIE deduction allocable to a member is equal to the amount of the member's current year BIE deduction divided by the amount of the group's aggregate current year BIE deduction.

(iii) Amount of foreign related current year BIE deduction status allocable to a member. The amount of foreign related current year BIE deduction status that is allocated to a member is determined by multiplying the group's foreign related current year BIE deduction (determined pursuant to paragraph (c)(3) of this section) by the percentage of current year BIE deduction allocable to such member (defined in paragraph (c)(4)(ii)(B) of this section).

(iv) Treatment of amounts as having unrelated current year BIE deduction status.

To the extent the amount of a member's current year BIE that is absorbed under paragraph (c)(2) of this section exceeds the domestic related current year BIE deduction status and foreign related current year BIE deduction status allocated to the member under paragraph (c)(4)(ii) and (iii) of this section, such excess amount is treated as from payments or accruals to an unrelated party.

(5) <u>Allocation of domestic related BIE carryforward status and foreign related BIE carryforward status to members of the group</u>--(i) <u>In general</u>. This paragraph (c)(5) applies in any year the consolidated group's aggregate current year BIE exceeds its section 163(j) limitation. After the application of paragraph (c)(4) of this section, any remaining domestic related current year BIE, foreign related current year BIE, and unrelated current year BIE is deemed to have been incurred pro-rata by members of the group pursuant to the rules in paragraph (c)(5)(ii), (iii), and (iv) of this section, regardless of which member or members actually incurred the business interest expense to a domestic related party, foreign related party, or unrelated party.

(ii) <u>Domestic related BIE carryforward</u>--(A) <u>Amount of domestic related BIE carryforward status allocable to a member</u>. The amount of domestic related BIE carryforward status that is allocated to a member equals the group's domestic related BIE carryforward from that year multiplied by the percentage of disallowed BIE carryforward allocable to the member.

(B) <u>Percentage of disallowed BIE carryforward allocable to a member</u>. The percentage of disallowed BIE carryforward allocable to a member for a taxable year equals the member's disallowed BIE carryforward from that year divided by the consolidated group's disallowed BIE carryforwards from that year.

(iii) Amount of foreign related BIE carryforward status allocable to a member. The amount of foreign related BIE carryforward status that is allocated to a member equals the group's foreign related BIE carryforward from that year multiplied by the percentage of disallowed BIE carryforward allocable to the member (as defined in paragraph (c)(5)(ii)(B) of this section).

(iv) Treatment of amounts as having unrelated BIE carryforward status. If a member's disallowed BIE carryforward for a year exceeds the amount of domestic related BIE carryforward status and foreign related BIE carryforward status that is allocated to the member pursuant to paragraphs (c)(5)(ii) and (iii) of this section, respectively, the excess carryforward amount is treated as from payments or accruals to an unrelated party.

(v) Coordination with section 381. If a disallowed BIE carryforward is allocated a status as a domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward under the allocation rule of paragraph (c)(5) of this section, the acquiring corporation in a transaction described in section 381(a) will succeed to and take into account the allocated status of the carryforward for purposes of section 59A. See §1.381(c)(20)-1.

(6) Member deconsolidates from a consolidated group. When a member deconsolidates from a group (the original group), the member's disallowed BIE

carryforwards retain their allocated status, pursuant to paragraph (c)(5) of this section, as a domestic related BIE carryforward, foreign related BIE carryforward, or unrelated BIE carryforward (as applicable). Following the member's deconsolidation, no other member of the original group is treated as possessing the domestic related BIE carryforward status, foreign related BIE carryforward status, or unrelated BIE carryforward status that is carried forward by the departing member.

(7) Corporation joins a consolidated group. If a corporation joins a consolidated group (the acquiring group), and that corporation was allocated a domestic related BIE carryforward status, foreign related BIE carryforward status, or unrelated BIE carryforward status pursuant to paragraph (c)(5) of this section from another consolidated group (the original group), or separately has a disallowed BIE carryforward that is classified as from payments or accruals to a domestic related party, foreign related party, or unrelated party, the status of the carryforward is taken into account in determining the acquiring group's base erosion tax benefit when the corporation's disallowed BIE carryforward is absorbed.

(d) Allocation of the base erosion minimum tax amount to members of the consolidated group. For rules regarding the allocation of the base erosion minimum tax amount, see section 1552. Allocations under section 1552 take into account the classification and allocation provisions of paragraphs (c)(3) through (5) of this section.

(e) Definitions. The following definitions apply for purposes of this section –

(1) Aggregate current year BIE. The consolidated group's aggregate current

year BIE is the aggregate of all members' current year BIE.

(2) Aggregate current year BIE deduction. The consolidated group's aggregate current year BIE deduction is the aggregate of all members' current year BIE deductions.

(3) Applicable taxpayer. The term applicable taxpayer has the meaning provided in §1.59A-2(b).

(4) Base erosion minimum tax amount. The consolidated group's base erosion minimum tax amount is the tax imposed under section 59A.

(5) Base erosion tax benefit. The term base erosion tax benefit has the meaning provided in §1.59A-3(c)(1).

(6) Business interest expense. The term business interest expense, with respect to a member and a taxable year, has the meaning provided in §1.163(j)-1(b)(2), and with respect to a consolidated group and a taxable year, has the meaning provided in §1.163(j)-4(d)(2)(iii).

(7) Consolidated group's disallowed BIE carryforwards. The term consolidated group's disallowed BIE carryforwards has the meaning provided in §1.163(j)-5(b)(3)(i).

(8) Current year BIE. A member's current year BIE is the member's business interest expense that would be deductible in the current taxable year without regard to section 163(j) and that is not a disallowed business interest expense carryforward from a prior taxable year.

(9) Current year BIE deduction. A member's current year BIE deduction is the

member's current year BIE that is permitted as a deduction in the taxable year.

(10) Domestic related BIE carryforward. The consolidated group's domestic related BIE carryforward for any taxable year is the excess of the group's domestic related current year BIE over the group's domestic related current year BIE deduction (if any).

(11) Domestic related current year BIE. The consolidated group's domestic related current year BIE for any taxable year is the consolidated group's aggregate current year BIE paid or accrued to a domestic related party.

(12) Domestic related current year BIE deduction. The consolidated group's domestic related current year BIE deduction for any taxable year is the portion of the group's aggregate current year BIE deduction classified as from interest paid or accrued to a domestic related party under paragraph (c)(3) of this section.

(13) Domestic related party. A domestic related party is a related party that is not a foreign related party and is not a member of the same consolidated group.

(14) Disallowed BIE carryforward. The term disallowed BIE carryforward has the meaning provided in §1.163(j)-1(b)(9).

(15) Foreign related BIE carryforward. The consolidated group's foreign related BIE carryforward for any taxable year, is the excess of the group's foreign related current year BIE over the group's foreign related current year BIE deduction (if any).

(16) Foreign related current year BIE. The consolidated group's foreign related current year BIE for any taxable year is the consolidated group's aggregate current year

BIE paid or accrued to a foreign related party.

(17) Foreign related current year BIE deduction. The consolidated group's foreign related current year BIE deduction for any taxable year is the portion of the consolidated group's aggregate current year BIE deduction classified as from interest paid or accrued to a foreign related party under paragraph (c)(3) of this section.

(18) Foreign related party. A foreign related party has the meaning provided in §1.59A-1(b)(12).

(19) Related party. The term related party has the meaning provided in §1.59A-1(b)(17), but excludes members of the same consolidated group.

(20) Section 163(j) interest deduction. The term section 163(j) interest deduction means, with respect to a taxable year, the amount of the consolidated group's business interest expense permitted as a deduction pursuant to §1.163(j)-5(b)(3) in the taxable year.

(21) Section 163(j) limitation. The term section 163(j) limitation has the meaning provided in §1.163(j)-1(b)(31).

(22) Unrelated BIE carryforward. The consolidated group's unrelated BIE carryforward for any taxable year is the excess of the group's unrelated current year BIE over the group's unrelated current year BIE deduction.

(23) Unrelated current year BIE. The consolidated group's unrelated current year BIE for any taxable year is the consolidated group's aggregate current year BIE paid or accrued to an unrelated party.

(24) Unrelated current year BIE deduction. The consolidated group's unrelated current year BIE deduction for any taxable year is the portion of the group's aggregate current year BIE deduction classified as from interest paid or accrued to an unrelated party under paragraph (c)(3) of this section.

(25) Unrelated party. An unrelated party is a party that is not a related party.

(f) Examples. The following examples illustrate the general application of this section. For purposes of the examples, a foreign corporation (FP) wholly owns domestic corporation (P), which in turn wholly owns S1 and S2. P, S1, and S2 are members of a consolidated group. The consolidated group is a calendar year taxpayer.

(1) Example 1: Computation of the consolidated group's base erosion minimum tax amount. (i) The consolidated group is the applicable taxpayer. (A) Facts. The members have never engaged in intercompany transactions. For the 2019 taxable year, P, S1, and S2 were permitted the following amounts of deductions (within the meaning of section 59A(c)(4)), $2,400x, $1,000x, and $2,600x; those deductions include base erosion tax benefits of $180x, $370x, and $230x. The group's consolidated taxable income for the year is $150x. In addition, the group satisfies the gross receipts test in §1.59A-2(d).

(B) Analysis. Pursuant to paragraph (b) of this section, the receipts and deductions of P, S1, and S2 are aggregated for purposes of making the computations under section 59A. The group's base erosion percentage is 13% (($180x + $370x + $230x)/($2,400x + $1,000x + $2,600x)). The consolidated group is an applicable taxpayer under §1.59A-2(b) because the group satisfies the gross receipts test and the group's base erosion percentage (13%) is higher than 3%. The consolidated group's modified taxable income is computed by adding back the members' base erosion tax benefits (and, when the consolidated group has consolidated net operating loss available for deduction, the consolidated net operating loss allowed times base erosion percentage) to the consolidated taxable income, $930x ($150x + $180x + $370x + $230x). The group's base erosion minimum tax amount is then computed as 10 percent of the modified taxable income less the regular tax liability, $61.5x ($930x × 10% - $150x × 21%).

(ii) The consolidated group engages in intercompany transactions. (A) Facts. The facts are the same as in paragraph (f)(1)(i)(A) of this section (the facts in Example 1(i)), except that S1 sold various inventory items to S2 during 2019. Such items are depreciable in the hands of S2 (but would not have been depreciable in the hands of S1) and continued to be owned by S2 during 2019.

(B) Analysis. The result is the same as paragraph (f)(1)(i)(A) of this section (the facts in Example 1(i)),. Pursuant to paragraph (b)(2) of this section, items resulting from the intercompany sale (for example, gross receipts, depreciation deductions) are not taken into account in computing the group's gross receipts under §1.59A-2(d) and base erosion percentage under §1.59A-2(e)(3).

(2) Example 2: Business interest expense subject to section 163(j) and the group's domestic related current year BIE and foreign related current year BIE for the year equals its section 163(j) limitation. (i) Facts. During the current year (Year 1), P incurred $150x of business interest expense to domestic related parties; S1 incurred $150x of business interest expense to foreign related parties; and S2 incurred $150x of business interest expense to unrelated parties. The group's section 163(j) limitation for the year is $300x. After applying the rules in §1.163(j)-5(b)(3), the group deducts $150x of P's Year 1 business interest expense, and $75x each of S1 and S2's Year 1 business interest expense. Assume the group is an applicable taxpayer for purposes of section 59A.

(ii) Analysis—(A) Application of the absorption rule in paragraph (c)(2) of this section. Following the rules in section 163(j), the group's section 163(j) interest deduction for Year 1 is $300x, and the entire amount is from members' Year 1 business interest expense.

(B) Application of the classification rule in paragraph (c)(3) of this section. Under paragraph (c)(3) of this section, the group's aggregate current year BIE deduction of $300x is first classified as payments or accruals to related parties (pro-rata among domestic related parties and foreign related parties), and second as payments or accruals to unrelated parties. For Year 1, the group has $150x of domestic related current year BIE and $150x of foreign related current year BIE, and the group's aggregate current year BIE deduction will be classified equally among the related party expenses. Therefore, $150x of the group's deduction is classified as domestic related current year BIE deduction and $150x is classified as a foreign related current year BIE deduction.

(C) Application of the allocation rule in paragraph (c)(4) of this section. After the application of the classification rule in paragraph (c)(3) of this section, the group has

$150x each of domestic related current year BIE deduction and foreign related current year BIE deduction from the group's aggregate current year BIE in Year 1. The domestic related current year BIE deduction and foreign related current year BIE deduction will be allocated to P, S1, and S2 based on each member's deduction of its Year 1 business interest expense.

(1) Allocations to P. The percentage of current year BIE deduction attributable to P is 50% (P's deduction of its Year 1 current year BIE, $150x, divided by the group's aggregate current year BIE deduction for Year 1, $300x). Thus, the amount of domestic related current year BIE deduction status allocated to P is $75x (the group's domestic related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to P, 50%); and the amount of foreign related current year BIE deduction status allocated to P is $75x (the group's foreign related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to P, 50%).

(2) Allocations to S1 and S2. The percentage of current year BIE deduction attributable to S1 is 25% (S1's deduction of its Year 1 current year BIE, $75x, divided by the group's aggregate current year BIE deduction for Year 1, $300x). Thus, the amount of domestic related current year BIE deduction status allocated to S1 is $37.5x (the group's domestic related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to S1, 25%); and the amount of foreign related current year BIE deduction status allocated to S1 is $37.5x (the group's foreign related current year BIE deduction, $150x, multiplied by the percentage of current year BIE deduction allocable to S1, 25%). Because S2 also deducted $75 of its Year 1 current year BIE, S2's deductions are allocated the same pro-rata status as those of S1 under this paragraph (f)(2)(ii)(C)(2).

(D) Application of the allocation rule in paragraph (c)(5) of this section. Although the group will have disallowed BIE carryforwards after Year 1 (the group's aggregate current year BIE of $450x ($150x + $150x + $150x) exceeds the section 163(j) limitation of $300x), all of the domestic related current year BIE and foreign related current year BIE in Year 1 has been taken into account pursuant to the classification rule in paragraph (c)(3) of this section. Thus, under paragraph (c)(5)(iv) of this section, each member's disallowed BIE carryforward is treated as from payments or accruals to unrelated parties.

(3) Example 3: Business interest expense subject to section 163(j). (i) The group's domestic related current year BIE and foreign related current year BIE for the year exceeds its section 163(j) limitation. (A) Facts. During the current year (Year 1), P incurred $60x of business interest expense to domestic related parties; S1 incurred

$40x of business interest expense to foreign related parties; and S2 incurred $80x of business interest expense to unrelated parties. The group's section 163(j) limitation for the year is $60x. After applying the rules in §1.163(j)-5(b)(3), the group deducts $20x each of P, S1, and S2's current year business interest expense. Assume the group is an applicable taxpayer for purposes of section 59A.

(B) Analysis—(1) Application of the absorption rule in paragraph (c)(2) of this section. Following the rules in section 163(j), the group's section 163(j) interest deduction is $60x, and the entire amount is from members' Year 1 business interest expense.

(2) Application of the classification rule in paragraph (c)(3) of this section. Under paragraph (c)(3) of this section, the group's $60x of aggregate current year BIE deduction is first classified as payments or accruals to related parties (pro-rata among domestic related parties and foreign related parties), and second as payments or accruals from unrelated parties. The group's total related party interest expense in Year 1, $100x (sum of the group's Year 1 domestic related current year BIE, $60x, and the group's Year 1 foreign related current year BIE, $40x), exceeds the group's aggregate current year BIE deduction of $60x. Thus, the group's aggregate current year BIE deduction will be classified, pro-rata, as from payments or accruals to domestic related parties and foreign related parties. Of the group's aggregate current year BIE deduction in Year 1, $36x is classified as a domestic related current year BIE deduction (the group's aggregate current year BIE deduction, $60x, multiplied by the ratio of domestic related current year BIE over the group's total Year 1 related party interest expense ($60x / ($60x+$40x))); and $24x of the group's aggregate current year BIE deduction is classified as a foreign related current year BIE deduction (the group's section 163(j) interest deduction, $60x, multiplied by the ratio of foreign related current year BIE over the group's total Year 1 related party interest expense ($40x / ($60x+$40x))).

(3) Application of the allocation rule in paragraph (c)(4) of this section. After the application of the classification rule in paragraph (c)(3) of this section, the group has $36x of domestic related current year BIE deduction and $24x of foreign related current year BIE deduction from the group's aggregate current year BIE in Year 1. The domestic related current year BIE deduction and foreign related current year BIE deduction will be allocated to P, S1, and S2 based on each member's current year BIE deduction in Year 1.

(i) Allocation of the group's domestic related current year BIE deduction status. Because each member is deducting $20x of its Year 1 business interest expense, all three members have the same percentage of current year BIE deduction attributable to them. The percentage of current year BIE deduction attributable to each of P, S1, and

S2 is 33.33% (each member's current year BIE deduction in Year 1, $20x, divided by the group's aggregate current year BIE deduction for Year 1, $60x). Thus, the amount of domestic related current year BIE deduction status allocable to each member is $12x (the group's domestic related current year BIE deduction, $36x, multiplied by the percentage of current year BIE deduction allocable to each member, 33.33%).

(ii) Allocations of the group's foreign related current year BIE deduction status. The amount of foreign related current year BIE deduction status allocable to each member is $8x (the group's foreign related current year BIE deduction, $24x, multiplied by the percentage of current year BIE deduction allocable to each member, 33.33%, as computed earlier in paragraph (f)(3) of this section (Example 3).

(4) Application of the allocation rule in paragraph (c)(5) of this section. In Year 1 the group has $60x of domestic related current year BIE, of which $36x is deducted in the year (by operation of the classification rule). Therefore, the group has $24x of domestic related BIE carryforward. Similarly, the group has $40x of foreign related current year BIE in Year 1, of which $24x is deducted in the year. Therefore, the group has $16x of foreign related BIE carryforward. The $24x domestic related BIE carryforward status and $16x foreign related BIE carryforward status will be allocated to P, S1, and S2 in proportion to the amount of each member's disallowed BIE carryforward.

(i) Allocation to P. The percentage of disallowed BIE carryforward allocable to P is 33.33% (P's Year 1 disallowed BIE carryforward, $40x ($60x-$20x), divided by the group's Year 1 disallowed BIE carryforward, $120x ($60x + $40x + 80x - $60x)). Thus, the amount of domestic related BIE carryforward status allocated to P is $8x (the group's domestic related BIE carryforward, $24x, multiplied by the percentage of disallowed BIE carryforward allocable to P, 33.33%); and the amount of foreign related BIE carryforward status allocated to P is $5.33x (the group's foreign related BIE carryforward, $16x, multiplied by the percentage of disallowed BIE carryforward allocable to P, 33.33%). Under paragraph (c)(5)(iv) of this section, P's disallowed BIE carryforward that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party. Therefore, $26.67x ($40x P's disallowed BIE carryforward - $8x domestic related BIE carryforward status allocated to P - $5.33x foreign related BIE carryforward status allocated to P) is treated as interest paid or accrued to an unrelated party.

(ii) Allocation to S1. The percentage of disallowed BIE carryforward allocable to S1 is 16.67% (S1's Year 1 disallowed BIE carryforward, $20x ($40x - $20x), divided by the group's Year 1 disallowed BIE carryforward, $120x ($60x + $40x + 80x - $60x).

Thus, the amount of domestic related BIE carryforward status allocated to S1 is $4x (the group's domestic related BIE carryforward, $24x, multiplied by the percentage of disallowed BIE carryforward allocable to S1, 16.67%); and the amount of foreign related BIE carryforward status allocated to S1 is $2.67x (the group's foreign related BIE carryforward, $16x, multiplied by the percentage of disallowed BIE carryforward allocable to S1, 16.67%). Under paragraph (c)(5)(iv) of this section, S1's disallowed BIE that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party. Therefore, $13.33x ($20x S1's disallowed BIE carryforward - $4x domestic related BIE carryforward status allocated to S1 - $2.67x foreign related BIE carryforward status allocated to S1) is treated as interest paid or accrued to an unrelated party.

(iii) Allocation to S2. The percentage of disallowed BIE carryforward allocable to S2 is 50% (S2's Year 1 disallowed BIE carryforward, $60x ($80x-$20x), divided by the group's Year 1 disallowed BIE carryforward, $120x ($60x+$40x+80x-$60x). Thus, the amount of domestic related BIE carryforward status allocated to S2 is $12x (the group's domestic related BIE carryforward, $24x, multiplied by the percentage of disallowed BIE carryforward allocable to S2, 50%); and the amount of foreign related BIE carryforward status allocated to S2 is $8x (the group's foreign related BIE carryforward, $16x, multiplied by the percentage of disallowed BIE carryforward allocable to S2, 50%). Under paragraph (c)(5)(iv) of this section, S2's disallowed BIE that has not been allocated a status as either a domestic related BIE carryforward or a foreign related BIE carryforward will be treated as interest paid or accrued to an unrelated party. Therefore, $40x ($60x S2's disallowed BIE carryforward - $12x domestic related BIE carryforward status allocated to S2 - $8x foreign related BIE carryforward status allocated to S2) is treated as interest paid or accrued to an unrelated party.

(ii) The group deducting its disallowed BIE carryforwards. (A) Facts. The facts are the same as in paragraph (f)(3)(i)(A) of this section (the facts in Example 3(i)), and in addition, none of the members incurs any business interest expense in Year 2. The group's section 163(j) limitation for Year 2 is $30x.

(B) Analysis—(1) Application of the absorption rule in paragraph (c)(2) of this section. Following the rules in section 163(j), each member of the group is deducting $10x of its disallowed BIE carryforward from Year 1. Therefore, the group's section 163(j) deduction for Year 2 is $30x.

(2) Application of the classification rule in paragraph (c)(3) of this section. Under paragraph (c)(3)(iv) of this section, to the extent members are deducting their Year 1 disallowed BIE carryforward in Year 2, the classification rule will apply to the deduction

in Year 2 after the allocation rule in paragraph (c)(5) of this section has allocated the related and unrelated party status to the member's disallowed BIE carryforward in Year 1. The allocation required under paragraph (c)(5) of this section is described in paragraph (f)(3)(i)(B)(4) of this section.

(i) Use of P's allocated domestic related BIE carryforward status and foreign related BIE carryforward status. P has $40x of Year 1 disallowed BIE carryforward, and P was allocated $8x of domestic related BIE carryforward status and $5.33x of foreign related BIE carryforward status. In Year 2, P deducts $10x of its Year 1 disallowed BIE carryforward. Under the classification rule of paragraph (c)(3) of this section, P is treated as deducting pro-rata from its allocated status of domestic related BIE carryforward and foreign related BIE carryforward. Therefore, P is treated as deducting $6x of its allocated domestic related BIE carryforward ($10x × $8x / ($8x + $5.33x)), and $4x of its allocated foreign related BIE carryforward ($10x × $5.33x / $8x + $5.33x)). After Year 2, P has remaining $30x of Year 1 disallowed BIE carryforward, of which $2x has a status of domestic related BIE carryforward, $1.33x has the status of foreign related BIE carryforward, and $26.67x of interest treated as paid or accrued to unrelated parties.

(ii) Use of S1's allocated domestic related BIE carryforward status and foreign related BIE carryforward status. S1 has $20x of Year 1 disallowed BIE carryforward, and S1 was allocated $4x of domestic related BIE carryforward status and $2.67x of foreign related BIE carryforward status. In Year 2, S2 deducts $10x of its Year 1 disallowed BIE carryforward. Because S2's deduction of its Year 1 disallowed BIE carryforward, $10x, exceeds its allocated domestic related BIE carryforward status ($4x) and foreign related BIE carryforward status ($2.67x), all of the allocated related party status are used up. After Year 2, all of S1's Year 1 disallowed BIE carryforward, $10x, is treated as interest paid or accrued to an unrelated party.

(iii) Use of S2's allocated domestic related BIE carryforward status and foreign related BIE carryforward status. S2 has $60x of Year 1 disallowed BIE carryforward, and S2 was allocated $12x of domestic related BIE carryforward status and $8x of foreign related BIE carryforward status. In Year 2, S2 deducts $10x of its Year 1 disallowed BIE carryforward. Under the classification rule of paragraph (c)(3) of this section, S2 is treated as deducting $6x of its allocated domestic related BIE carryforward ($10x × $12x / ($12x + $8x)), and $4x of its allocated foreign related BIE carryforward ($10x × $8x / $8x + $12x)). After Year 2, P has remaining $50x of Year 1 disallowed BIE carryforward, of which $6x has a status of domestic related BIE carryforward, $4x has the status of foreign related BIE carryforward, and $40x of interest treated as paid or accrued to unrelated parties.

(g) Applicability date--(1) In general. Except as provided in this paragraph (g), this section applies to taxable years beginning after December 31, 2017.

(2) Application of section 59A if S joins a consolidated group with a taxable year beginning before January 1, 2018. If during calendar year 2018 a corporation (S) joins a consolidated group during a consolidated return year beginning before January 1, 2018, then section 59A will not apply to S's short taxable year that is included in the group's consolidated return year, even though S's short taxable year begins after December 31, 2017.

Par. 9. Section 1.1502-100 is amended by revising paragraph (b) to read as follows:

§1.1502-100 Corporations exempt from tax.

* * * * *

(b) The tax liability for a consolidated return year of an exempt group is the tax imposed by section 511(a) on the consolidated unrelated taxable income for the year (determined under paragraph (c) of this section), and by allowing the credits provided in §1.1502-2(b).

* * * * *

Par. 10. Section 1.6038A-1 is amended by adding a sentence to the end of paragraph (n)(2) and revising the last sentence of paragraph (n)(3) to read as follows:

§1.6038A-1 General requirements and definitions.

* * * * *

(n) * * *

(2) * * * Section 1.6038A-2(a)(3), (b)(6), and (b)(7) apply for taxable years beginning after December 31, 2017.

(3) * * * For taxable years ending on or before December 31, 2017, see §1.6038A-4 as contained in 26 CFR part 1 revised as of April 1, 2018.

* * * * *

Par. 11. Section 1.6038A-2 is amended by

1. Revising the headings for paragraphs (a) and (a)(1).

2. Revising paragraph (a)(2).

3. Adding paragraph (a)(3).

4. Revising paragraphs (b)(1)(ii), (b)(2)(iv), and the second sentence of paragraph (b)(3).

5. Redesignating paragraphs (b)(6) through (b)(9) as paragraphs (b)(8) through (b)(11).

6. Adding new paragraphs (b)(6) and (7).

7. Revising paragraph (c) and the first sentence of paragraph (d).

8. Removing the language “Paragraph (b)(8)” from the second sentence of paragraph (g) and adding the language “Paragraph (b)(10)” in its place.

9. Adding two sentences to the end of paragraph (g).

The revisions and additions read as follows:

§1.6038A-2 Requirement of return.

(a) Forms required. (1) Form 5472. * * *

(2) Reportable transaction. A reportable transaction is any transaction of the types listed in paragraphs (b)(3) and (4) of this section, and, in the case of a reporting corporation that is an applicable taxpayer, as defined under §1.59A-2(b), any other arrangement that, to prevent avoidance of the purposes of section 59A, is identified on Form 5472 as a reportable transaction. However, except as the Secretary may prescribe otherwise for an applicable taxpayer, the transaction is not a reportable transaction if neither party to the transaction is a United States person as defined in section 7701(a)(30) (which, for purposes of section 6038A, includes an entity that is a reporting corporation as a result of being treated as a corporation under §301.7701-2(c)(2)(vi) of this chapter) and the transaction--

(i) Will not generate in any taxable year gross income from sources within the United States or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, and

(ii) Will not generate in any taxable year any expense, loss, or other deduction that is allocable or apportionable to such income.

(3) Form 8991. Each reporting corporation that is an applicable taxpayer, as defined under §1.59A-2(b), must make an annual information return on Form 8991. The obligation of an applicable taxpayer to report on Form 8991 does not depend on applicability of tax under section 59A or obligation to file Form 5472.

(b) * * *

(1) * * *

(ii) The name, address, and U.S. taxpayer identification number, if applicable, of all its direct and indirect foreign shareholders (for an indirect 25-percent foreign shareholder, explain the attribution of ownership); whether any 25-percent foreign shareholder is a surrogate foreign corporation under section 7874(a)(2)(B) or a member of an expanded affiliated group as defined in section 7874(c)(1); each country in which each 25-percent foreign shareholder files an income tax return as a resident under the tax laws of that country; the places where each 25-percent shareholder conducts its business; and the country or countries of organization, citizenship, and incorporation of each 25-percent foreign shareholder.

* * * * *

(2) * * *

(iv) The relationship of the reporting corporation to the related party (including, to the extent the form may prescribe, any intermediate relationships).

(3) * * * The total amount of such transactions, as well as the separate amounts for each type of transaction described below, and, to the extent the form may prescribe, any further description, categorization, or listing of transactions within these types, must be reported on Form 5472, in the manner the form prescribes. * * *

* * * * *

(6) Compilation of reportable transactions across multiple related parties. A reporting corporation must, to the extent and in the manner Form 5472 may prescribe, include a schedule tabulating information with respect to related parties for which the reporting corporation is required to file Forms 5472. The schedule will not require information (beyond totaling) that is not required for the individual Forms 5472. The schedule may include the following:

(i) The identity and status of the related parties;

(ii) The reporting corporation's relationship to the related parties;

(iii) The reporting corporation's reportable transactions with the related parties; and

(iv) Other items required to be reported on Form 5472.

(7) Information on Form 5472 and Form 8991 regarding base erosion payments. If any reporting corporation is an applicable taxpayer, as defined under §1.59A-2(b), it must report the information required by Form 8991 and by any Form 5472 it is required to file, regarding:

(i) Determination of whether a taxpayer is an applicable taxpayer;

(ii) Computation of base erosion minimum tax amount, including computation of regular tax liability as adjusted for purposes of computing base erosion minimum tax amount;

(iii) Computation of modified taxable income;

(iv) Base erosion tax benefits;

(v) Base erosion percentage calculation;

(vi) Base erosion payments;

(vii) Amounts with respect to services as described in §1.59A-3(b)(3)(i), including a breakdown of the amount of the total services cost and any mark-up component;

(viii) Arrangements or transactions described in §1.59A-9;

(ix) Any qualified derivative payment, including:

(A) The aggregate amount of qualified derivative payments for the taxable year, including as determined by type of derivative contract;

(B) The identity of each counterparty and the aggregate amount of qualified derivative payments made to that counterparty; and

(C) A representation that all payments satisfy the requirements of §1.59A-6(b)(2), and

(x) Any other information necessary to carry out section 59A.

* * * * *

(c) Method of reporting. All statements required on or with the Form 5472 or Form 8991 under this section and §1.6038A-5 must be in the English language. All amounts required to be reported under paragraph (b) of this section must be expressed in United States currency, with a statement of the exchange rates used, and, to the extent the forms may require, must indicate the method by which the amount of a reportable transaction or item was determined.

(d) * * * A Form 5472 and Form 8991 required under this section must be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. * * *

* * * * *

(g) * * * Paragraph (b)(7)(ix) of this section applies to taxable years beginning one year after final regulations are published in the **Federal Register**. Before these regulations are applicable, a taxpayer will be treated as satisfying the reporting requirement described in §1.59A-6(b)(2) only to the extent that it reports the aggregate amount of qualified derivative payments on Form 8991.

§1.6038A-4 [Amended]

Par. 12. For each paragraph listed in the table, remove the language in the "Remove" column from wherever it appears and add in its place the language in the "Add" column as set forth below:

Section	Remove	Add
Section 1.6038A-4(a)(1)	$10,000	$25,000
Section 1.6038A-4(a)(3)	$10,000	$25,000
Section 1.6038A-4(d)(1)	$10,000	$25,000
Section 1.6038A-4(d)(4)	$10,000	$25,000
Section 1.6038A-4(f)	$10,000	$25,000
Section 1.6038A-4(f)	$30,000	$75,000

Section 1.6038A-4(f)	$90,000	$225,000

§1.6655-5 [Amended]

Par. 13. Section 1.6655-5 is amended by removing the language “§1.1502-2(h)” in paragraph (e) Example 10 and adding the language“§1.1502-1(h)” in its place.

Kirsten Wielobob

Deputy Commissioner for Services and Enforcement.

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