

## BASE EROSION PREVENTION

### ¶750 Base Erosion and Anti-Abuse Tax

#### NEW LAW EXPLAINED

**Tax on base erosion payments of taxpayers with substantial gross receipts imposed.**— Applicable taxpayers are required to pay for any tax year a tax equal to the base erosion minimum tax amount for the year. The tax is paid in addition to any other income taxes imposed under Subtitle A of the Code (Code Sec. 59A(a), as added by the Tax Cuts and Jobs Act of 2017).

The base erosion minimum tax amount for any tax year is the excess, if any, of:

- 1) 10 percent (five percent for tax years beginning in calendar year 2018) of the modified taxable income of the taxpayer for the tax year, over
- 2) the regular tax liability for the tax year reduced (but not below zero) by the excess, if any, of:
  - a) the credits allowed against regular tax liability under Chapter 1 of the Code, over
  - b) the sum of (i) the credit allowed under Code Sec. 38 (the general business credit) that is allocable to the research credit determined under Code Sec. 41(a), plus (ii) the portion of the applicable Code Sec. 38 credits that do not exceed 80 percent of the lesser of the amounts of those credits or the base erosion minimum tax amount (Code Sec. 59A(b)(1), as added by the 2017 Tax Cuts Act).

For tax years beginning after December 31, 2025, for purposes of determining the base erosion minimum tax amount, the 10-percent rate is increased to 12.5 percent of the taxpayer's modified taxable income and the regular tax liability is reduced (but not below zero) by the aggregate amount of allowable credits, rather than the excess described in item (2), above, (Code Sec. 59A(b)(2), as added by the Tax Cuts and Jobs Act).

Applicable taxpayers that are members of an affiliated group that includes a bank or registered securities dealer under section 15(a) of the Securities Exchange Act of 1934 are subject to an additional increase of one percentage point in the tax rates, discussed above (i.e., 11 percent for tax years prior to December 31, 2025, and 13.5 percent for tax years beginning after December 31, 2025) (Code Sec. 59A(b)(3), as added by the 2017 Tax Cuts Act).

For purposes of the above computation, the applicable Code Sec. 38 credits are the credits allowed under Code Sec. 38 for the tax year that are properly allocable to:

- 1) the low-income housing credit under Code Sec. 42(a);
- 2) the low-income housing credit under Code Sec. 42(a);
- 3) the investment credit under Code Sec. 46, but only to the extent it is properly allocable to the Code Sec. 48 energy credit (Code Sec. 59A(b)(4), as added by the 2017 Tax Cuts Act).

An applicable taxpayer's modified taxable income is determined by computing the taxpayer's taxable income under Chapter 1 for the tax year without regard to (i) any base erosion tax benefit with respect to any base erosion payment, or (ii) the base erosion percentage of any net operating loss deduction allowed under Code Sec. 172 for the tax year (Code Sec. 59A(c)(1), as added by the 2017 Tax Cuts Act).

**Base erosion payment.** A base erosion payment is any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable under Chapter 1 of the Code (Code Sec. 59A(d)(1), as added by the 2017 Tax Cuts Act). These payments include any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation) (Code Sec. 59A(d)(2), as added by the 2017 Tax Cuts Act). A base erosion payment also includes any premium or other consideration paid or accrued by the taxpayer to a foreign person that is a related party of the taxpayer for any reinsurance payments

taken into account under Code Secs. 803(a)(1)(B) or 832(b)(4)(A) (Code Sec. 59A(d)(3), as added by the 2017 Tax Cuts Act).

## COMMENT

Base erosion payments generally do not include any amount that constitutes reductions in gross receipts including payments for costs of goods sold (COGS). However, an exception applies for certain payments to expatriated entities, described below.

Base erosion payments include any amount that results in a reduction of gross receipts of the taxpayer that is paid or accrued by the taxpayer with respect to: (1) a surrogate foreign corporation that is a related party of the taxpayer, but only if such corporation first became a surrogate foreign corporation after November 9, 2017, or (2) a foreign person that is a member of the surrogate foreign corporation's expanded affiliated group (EAG) (Code Sec. 59A(d)(4), as added by the 2017 Tax Cuts Act).

## PRACTICE NOTE

For this purpose, a surrogate foreign corporation is a foreign corporation that: (1) acquires (after March 4, 2003) substantially all of the properties held by a U.S. corporation, or substantially all of the properties constituting a trade or business of a domestic partnership, (2) after the acquisition, the U.S. corporation's former shareholders or the domestic partnership's former partners, own at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation, and (3) the surrogate foreign corporation's EAG does not have substantial business activities in the country where that corporation is organized or created compared to the total business activities of the EAG (Code Sec. 7874(a)(2)(B)). A surrogate foreign corporation does not include a foreign corporation treated as a domestic corporation under Code Sec. 7874(b) (where the former shareholders of the U.S. corporation or the former partners of the domestic partnership hold 80 percent or more (by vote or value) of the stock of the foreign acquiring corporation after the transaction). The EAG includes the foreign acquiring corporation and all companies connected to it by a chain of greater than 50-percent ownership (Code Sec. 7874(c)(1)).

A base erosion payment does not include any amount paid or accrued by a taxpayer for services, if such services meet the requirements for eligibility for use of the services cost method described in Reg. §1.482-9, determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure, and if the payments are made for services that have no markup component (Code Sec. 59A(d)(5), as added by the 2017 Tax Cuts Act).

**Exception for certain payments in the ordinary course of trade or business.** There is an exception provided for some types of payments made in the ordinary course of a trade or business. Under this exception, qualified derivative payments are generally not treated as base erosion payments (Code Sec. 59A(h)(1), as added by the 2017 Tax Cuts Act).

A qualified derivative payment is any payment made by a taxpayer pursuant to a derivative where the taxpayer:

- 1) recognizes gain or loss as if the derivative were sold for its fair market value (FMV) on the last business day of the tax year (and at additional times that are required by Title 26 or the taxpayer's method of accounting),
- 2) treats any gain or loss recognized as ordinary, and
- 3) treats the character of all items of income, deduction, gain or loss regarding a payment pursuant to the derivative as ordinary (Code Sec. 59A(h)(2)(A), as added by the 2017 Tax Cuts Act).

Payments are not treated as qualified derivative payments unless the taxpayer includes in the information required to be reported under Code Sec. 6038B(b)(2) information that is necessary to identify which

payments are to be treated as qualified derivative payments and such other information as the Secretary of the Treasury determines necessary (Code Sec. 59A(h)(2)(B), as added by the 2017 Tax Cuts Act).

The rule for qualified derivative payments does not apply if the payment would be treated as a base erosion payment if it was not made pursuant to a derivative (including royalty, interest or service payments) or where a contract has derivative and nonderivative component and the payment is allocable to the nonderivative component (Code Sec. 59A(h)(3), as added by the 2017 Tax Cuts Act).

For these purposes, a derivative is any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) whose value, or any payment or other transfer with respect to said contract, is (directly or indirectly) determined by reference to one or more of the following:

- 1) any share of stock of a corporation,
- 2) any evidence of indebtedness,
- 3) any commodity which is actively traded,
- 4) any currency,
- 5) any rate, price, amount, index, formula, or algorithm (Code Sec. 59A(h)(4)(A), as added by the 2017 Tax Cuts Act).

However, a derivative does not include any item described in items (1) through (5), above.

Except as otherwise provided by the Secretary, American depository receipts (and similar instruments), with respect to shares of stock in foreign corporations, are treated as shares of stock in such foreign corporations for purposes of Part VII, Subchapter A of Chapter 1 (Code Sec. 59A(h)(4)(B), as added by the 2017 Tax Cuts Act).

In addition, a derivative 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 where subchapter L would apply if such foreign corporation were a domestic corporation (Code Sec. 59A(h)(4)(C), as added by the 2017 Tax Cuts Act).

**Base erosion tax benefit.** A base erosion tax benefit includes:

- 1) any deduction allowed under Chapter 1 for the tax year with respect to any base erosion payment;
- 2) for base erosion payments made to purchase property subject to depreciation (or amortization in lieu of depreciation), any deduction allowed in Chapter 1 for depreciation (or amortization in lieu of depreciation) for the tax year with respect to the property acquired with the payment;
- 3) in the case of reinsurance payments, any reduction under Code Sec. 803(a)(1)(B) for the gross amounts or premiums or other consideration on insurance, annuity contracts or indemnity insurance, and any deduction under Code Sec. 832(b)(4)(A) from the amount of gross premiums written on insurance contracts during the tax year for the premiums paid for reinsurance; and
- 4) in the case of a payment to with respect to a surrogate foreign corporation or a foreign member of that corporation's expanded affiliated group, any reduction in gross receipts with respect to that payment in computing the taxpayer's gross income for the tax year (Code Sec. 59A(c)(2)(A), as added by the 2017 Tax Cuts Act).

The base erosion tax benefit attributable to any base erosion payment on which tax is imposed by Code Secs. 871 and 881, and with respect to which tax has been deducted and withheld under Code Secs. 1441 and 1442, is not taken into account in computing modified taxable income. However, the amount not taken into account in computing modified taxable income is reduced under rules similar to the rules under Code Sec. 163(j)(5)(B), as in effect before December 22, 2017, the date of the enactment of the 2017 Tax Cuts Act (which determines whether interest is treated as tax-exempt to the extent of a treaty reduction) (Code Sec. 59A(c)(2)(B), as added by the 2017 Tax Cuts Act).

For purposes of determining an applicable taxpayer's modified taxable income, in the case of a taxpayer to which Code Sec. 163(j) applies for the tax year, the reduction in the amount of interest for which a

deduction is allowed by reason of that provision 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 (Code Sec. 59A(c)(3), as added by the 2017 Tax Cuts Act).

**Base erosion percentage.** The base erosion percentage is the percentage, for any tax year, that is determined by dividing:

- 1) the aggregate amount of base erosion tax benefits of the taxpayer for the tax year, by
- 2) the aggregate amount of the deductions allowable to the taxpayer for the tax year, taking into account the base erosion tax benefits and disregarding (i) any deduction allowed under Code Secs. 172, 245A or 250 for the tax year, (ii) any deduction for amounts paid or accrued for services to which the exception for the services cost method (described in Reg. §1.482-9) applies, and (iii) any deduction for qualified derivative payments that are not treated as a base erosion payment (Code Sec. 59A(c)(4), as added by the 2017 Tax Cuts Act).

**Applicable taxpayer.** The base erosion tax applies to applicable taxpayers. Applicable taxpayers include corporations, other than a regulated investment company (RIC), a real estate investment trust (REIT), or an S corporation, that have average annual gross receipts of at least \$500 million over the past three tax years and a base erosion percentage of three percent for the tax year (two percent for taxpayers that are members of an affiliated group that includes a bank or registered securities dealer) (Code Sec. 59A(e)(1), as added by the 2017 Tax Cuts Act).

In the case of a foreign person (that is, any person who is not a U.S. person) the gross receipts of which are taken into account for purposes of this provision, the gross receipts test described above generally only takes into account gross receipts that are taken into account in determining ECI. This rule does not apply to the gross receipts of any U.S. person that are aggregated with the gross receipts of a foreign person under the aggregation rules, discussed below. In determining gross receipts, rules similar to the rules of Code Sec. 448(c)(3)(B), (C), and (D) apply (Code Sec. 59A(e)(2), and (f), as added by the 2017 Tax Cuts Act).

Under the aggregation rules, persons treated as a single employer under Code Sec. 52(a) are treated as one person for purposes of determining the average annual gross receipts and the base erosion percentage, except that the exception for foreign corporations under Code Sec. 1563(b)(2)(C) is disregarded (Code Sec. 59A(e)(3), as added by the 2017 Tax Cuts Act).

#### COMMENT

Accordingly, if a foreign person's gross receipts are aggregated with a U.S. person's gross receipts, the gross receipts of the U.S. person that are aggregated with the foreign person's gross receipts are not limited to the gross receipts taken into account in determining ECI.

**Related party.** For purposes of the base erosion tax rules, a related party is (i) any 25-percent owner (of the vote or value) of the taxpayer, (ii) any person who is related to the taxpayer, or to any 25-percent owner (of the vote or value) of the taxpayer, within the meaning of Code Secs. 267(b) or 707(b)(1), and (iii) any other person related to the taxpayer within the meaning of Code Sec. 482 (Code Sec. 59A(g)(1), as added by the 2017 Tax Cuts Act).

A 25-percent owner with respect to any corporation is any person who owns at least 25 percent of (i) the total voting power of all classes of stock of a corporation entitled to vote, or (ii) the total value of all classes of stock of the corporation (Code Sec. 59A(g)(2), as added by the 2017 Tax Cuts Act).

For purposes determining a related party, the Code Sec. 318 constructive stock ownership rules apply to these related party rules except that "10-percent" is substituted for "50-percent" in Code Sec. 318(a)(2)(C), and Code Secs. 318(a)(3)(A), (B) and (C) do not apply to cause a U.S. person to own stock owned by a person who is not a U.S. person (Code Sec. 59A(g)(3), as added by the 2017 Tax Cuts Act).

**Regulatory authority.** The Secretary of the Treasury is authorized to prescribe such regulations or other guidance as may be necessary or appropriate to carry out this provision, including regulations providing

for such adjustments to the application of this provision necessary to prevent avoidance of the provision, including through: (1) the use of unrelated persons, conduit transactions, or other intermediaries, or (2) transactions or arrangements designed in whole or in part: (a) to characterize payments otherwise subject to this provision as payments not subject to this provision, or (b) to substitute payments not subject to this provision for payments otherwise subject to this provision. The regulations or other guidance may also include regulations for the application of the related party rules, including rules to prevent the avoidance of the exceptions to the application of Code Sec. 318 (Code Sec. 59A(i), as added by the 2017 Tax Cuts Act).

**Reporting requirements and penalties.** The Secretary of the Treasury is authorized to prescribe additional reporting requirements under Code Sec. 6038A relating to: (i) the name, principal place of business, and country or countries in which organized or resident of each person that is a related party to the reporting corporation, and that had any transaction with the reporting corporation during its tax year, (ii) the manner of relation between the reporting corporation and the person referred to in (i), and (iii) the transactions between the reporting corporation and each related foreign person (Code Sec. 6038A(b)(1), as amended by the 2017 Tax Cuts Act).

Additional information is required regarding base erosion payments. Specifically, for purposes of information reporting under Code Secs. 6038A and 6038C, if the reporting corporation or the foreign corporation to which Code Sec. 6038C applies is an applicable taxpayer, the information that may be required includes: (i) information that the Secretary determines necessary to determine the base erosion minimum tax amount, base erosion payments, and base erosion tax benefits of the taxpayer for purposes of Code Sec. 59A for the tax year, and (ii) such other information as the Secretary of the Treasury determines is necessary. For these purposes, any term used in this provision and Code Sec. 59A has the meaning as when used in Code Sec. 59A (Code Sec. 6038A(b)(2), as amended by the 2017 Tax Cuts Act).

The \$10,000 penalties for failure to furnish information or maintain records provided in Code Sec. 6038A(d)(1) and (2) are both increased to \$25,000 (Code Sec. 6038A(d)(1) and (2), as amended by the 2017 Tax Cuts Act).

**Other changes.** The base erosion and anti-abuse tax of Code Sec. 59A is excluded from regular tax liability for purposes of the limitation on nonrefundable personal credits (Code Sec. 26(b)(2)(B), as added by the 2017 Tax Cuts Act). The new law also clarifies that a foreign corporation engaged in a trade or business within the United States during the tax year is subject to tax under Code Secs. 11 and 59A on its taxable income that is effectively connected with the conduct of a U.S. trade or business (Code Sec. 882(a)(1), as amended by the 2017 Tax Cuts Act). In addition, for purposes of the rules allowing a corporation to apply for a quick refund of an overpayment of estimated tax and the rules for estimated tax payments by corporations, income tax liability also includes the Code Sec. 59A base erosion tax (Code Sec. 6425(c)(1)(A) and Code Sec. 6655(g)(1)(A), (e)(2)(A) and (e)(2)(B), as amended by the 2017 Tax Cuts Act).

**Effective date.** The amendments made by this section apply to base erosion payments (as defined in Code Sec. 59A(d), as added by the Tax Cuts and Jobs Act of 2017) paid or accrued in tax years beginning after December 31, 2017 (Act Sec. 14401(e) of the 2017 Tax Cuts Act).