United States

Treatment of Derivative Payments under the US Final BEAT Regulations

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This article provides a general background in respect of the US base erosion and anti-abuse tax, which is a minimum tax for taxpayers in international groups enacted by the United States, and discusses the treatment of payments in respect of derivatives and other financial instruments under the final Regulations.

1. Introduction

As part of US Public Law 115-97,[1] commonly referred to as the "Tax Cuts and Jobs Act", passed at the end of 2017, the United States adopted a base erosion and anti-abuse tax (BEAT) that imposes a minimum tax for taxpayers in international groups if the effective US tax would otherwise fall below 10%.[2]

Final Regulations[3] were released by the US Treasury and Internal Revenue Service at the end of 2019. The final Regulations retain the basic approach and structure of the proposed Regulations,[4] with certain revisions.

This article provides a general background in respect of the BEAT and discusses the treatment of payments in respect of derivatives and other financial instruments under the final Regulations.

2. Background: The BEAT

2.1. General rules

The minimum tax imposed is an amount equal to the excess of (i) 10% of a taxpayer's modified taxable income over (ii) the taxpayer's regular tax liability reduced by most credits allowed under the Code.[5] Modified taxable income is the taxpayer's regular taxable income increased by any base erosion tax benefit with respect to any "base erosion payment" and an adjustment for the taxpayer's NOL deduction, if any.[6] The term "base erosion payment" means:

- any amount paid or accrued by a taxpayer to a non-US related party and with respect to which a deduction is allowable under the US income tax;
- any amount paid or accrued by the taxpayer to a non-US related party in connection with the acquisition of property by the taxpayer from the non-US related party if the character of the property is subject to the allowance for depreciation (or amortization in lieu of depreciation);
- any premium or other consideration paid or accrued by the taxpayer to a non-US related party for any reinsurance payments; or
- 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 (i) a non-US corporation that is the result of an inversion transaction if at least 60% of stock of the non-US corporation is owned by US shareholders,[7] or (ii) a non-US person that is a member of the same expanded affiliated group as a corporation described in (i).[8]

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1. US: Public Law 115-97, 115th Cong. (22 Dec. 2017).
2. US: IRC sec. 59A.
3. US: TD 9885, 84 Fed. Reg. 66968 (6 Dec. 2019).
4. US: REG-104259-18, 83 Fed. Reg. 65956 (21 Dec. 2018).
5. US: IRC sec. 59A(b)(1).
6. US: IRC sec. 59A(c).
7. US: IRC sec. 59A(d)(4)(C)(i).
8. US: Treas. Reg. sec. 1.59A-3(b)(1).

A base erosion payment does not include an amount paid or incurred for services if such amount is the total services cost with no markup for a payer which has elected to use a services cost method.[9] A base erosion payment does not include a qualified derivative payment.[10] In general, a base erosion payment does not include amounts paid or accrued to a non-US related party that are subject to US 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.[11] The effectively connected exception only applies if the US taxpayer receives Form W-8-ECI from the non-US related party. If a non-US related party determines its taxable income pursuant to the business profits provisions of an applicable income tax treaty, amounts paid or accrued to the non-US related party that are taken into account in determining its taxable income are treated as base erosion payments.[12] A currency exchange loss on a payment to a non-US related party is not a base erosion payment.[13] The related non-currency payment may be a base erosion payment and is separately tested. A portion of amounts paid on total loss-absorbing capacity (TLAC) securities is not (or may not be) a base erosion payment.[14] The amount excluded for US TLAC securities is based upon the amount of TLAC securities required by the US Board of Governors of the US Federal Reserve. The amount excluded for non-US TLAC securities is based upon the lesser of (i) the amount of TLAC securities required by the US Board of Governors of the US Federal Reserve or (ii) the amount of TLAC securities required by the similar regulatory body of the country of the home office. Amounts paid or accrued before 1 January 2018 or carried forward from a taxable year before 1 January 2018, are not base erosion payments.[15] Amounts transferred to a non-US related party pursuant to certain corporate non-recognition provisions are not base erosion payments.[16] Finally, certain reinsurance payments to a non-US related regulated insurance company, if the amounts are properly allocable to amounts payable to a person who is not a related party, are not base erosion payments.[17]

“Base erosion tax benefit” means:

- a deduction allowed with respect to a base erosion payment;
- a deduction allowed for depreciation or amortization with respect to the purchase of property from a non-US related person; and
- deduction in respect of payments made to a non-US related party for reinsurance.[18]

The BEAT applies in regard to payments paid or incurred by a US corporation to a non-US corporation if both the non-US and US corporations are related, which generally requires a 50% level of common ownership, or if the non-US corporation is a 25% or more owner of the US corporation.[19] The BEAT is neither deductible nor creditable.[20]

Taxpayers potentially liable for this additional tax are corporations that have three-year average gross receipts in excess of USD 500 million and a “base erosion percentage” exceeding 3% (or 2% in the case of banks and securities dealers).[21] In testing the gross receipts of the taxpayer, all the gross receipts of the taxpayer’s affiliated group are taken into consideration[22] – except that the gross receipts of non-US persons are included only to the extent the non-US person’s gross receipts are effectively connected with a US trade or business.[23] The base erosion percentage is generally determined by dividing “base erosion tax benefits” by the amount of deductions allowable to the taxpayer for the taxable year.[24]

Special rules apply for taxable years beginning after 31 December 2025.[25]

2.2. Determining the base erosion percentage

The base erosion percentage creates a cliff effect for taxpayers that exceed the USD 500 million gross receipts threshold. If they are above the relevant base erosion percentage (2 or 3%), the taxpayer must calculate the taxpayer’s modified taxable income. If the taxpayer is below the relevant base erosion percentage, the taxpayer does not need to calculate modified taxable income.

9. US: IRC sec. 59A(d)(5).
10. US: Treas. Reg. sec. 1.59A-3(b)(3)(ii).
11. US: Treas. Reg. sec. 1.59A-3(b)(3)(iii).
12. US: Treas. Reg. sec. 1.59A-3(b)(3)(iii)(B).
13. US: Treas. Reg. sec. 1.59A-3(b)(3)(iv).
14. US: Treas. Reg. sec. 1.59A-3(b)(3)(v).
15. US: Treas. Reg. sec. 1.59A-3(b)(3)(vi) and (vii).
16. US: Treas. Reg. sec. 1.59A-3(b)(3)(viii).
17. US: Treas. Reg. sec. 1.59A-3(b)(3)(ix).
18. US: IRC sec. 59A(c)(2).
19. US: IRC sec. 59A(g).
20. US: IRC sec. 26(b)(2)(B).
21. US: IRC sec. 59A(e)(1).
22. US: IRC sec. 59A(e)(3).
23. US: IRC sec. 59A(e)(2).
24. US: IRC sec. 59A(c)(4).
25. US: IRC sec. 59A(b)(2).

This puts a premium on maximizing the denominator and minimizing the numerator in the calculation of the base erosion percentage.

The taxpayer's base erosion percentage for any taxable year is determined by dividing (i) 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 for the taxable year, by (ii) the sum of the aggregate amount of the deductions (including deductions for base erosion tax benefits) 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) for the taxable year attributable to payments to non-US related persons, purchases of depreciable or amortizable property, reinsurance payments or the reduction of gross receipts for the taxable year.[26]

However, certain items are not taken into account in the denominator in the calculation of the base erosion percentage. Except as provided in section 1.59A-2(e)(3)(viii) of the Regulations, relating to effectively connected income and the service cost method, the denominator is determined without taking into account:

- any net operating loss, dividends received deduction for non-US sourced dividends or deduction for non-US derived intangible income;
- any deduction for amounts paid or accrued for services to which the services cost exception applies;
- any deduction for qualified derivative payments that are not treated as base erosion payments;
- any exchange loss within the meaning of section 1.988-2 of the Regulations from a transaction under section 988 of the Code that is not treated as a base erosion payment;
- any deduction for amounts paid or accrued to non-US related parties with respect to TLAC securities and non-US TLAC securities that are not treated as base erosion payments;
- any reinsurance losses incurred and claims payments to a non-US related regulated insurance company if the amounts are properly allocable to amounts payable to a person who is not a related party; and
- any deduction not allowed in determining taxable income for the taxable year.[27]

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 of the Code, and the tax has been deducted and withheld under section 1441 or 1442 of the Code.[28]If any tax treaty between the United States and any foreign country reduces the rate of tax imposed by section 871 or 881 of the Code, the amount of base erosion tax benefit that is not taken into account is equal to the amount of the base erosion tax benefit that would otherwise be attributable to the payment without the exclusion for fully withheld taxes multiplied by a fraction of (i) the rate of tax imposed under the treaty; over (ii) the rate of tax imposed without regard to the treaty (usually 30% under current US law).[29]

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 US 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 determining the base erosion percentage.[30]For purposes of section 59A of the Code, a taxpayer computes its losses resulting from positions subject to a mark-to-market regime under the 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.[31]

Section 59A of the Code 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 taxpayer must compute the amount of gross receipts and base erosion payments for its aggregate group using its own taxable year and based on those corporations that are members of the aggregate group at the end of the taxable year.[32]Therefore, members with different taxable years may have different base erosion percentages.

26. US: Treas. Reg. sec. 1.59A-2(e)(3)(i).
27. US: Treas. Reg. sec. 1.59A-2(e)(3)(ii).
28. US: Treas. Reg. sec. 1.59A-3(c)(2).
29. US: Treas. Reg. sec. 1.59A-3(c)(3).
30. US: Treas. Reg. sec. !.59A-2(e)(3)(vi).
31. US: Treas. Reg. sec. !.59A-2(e)(3)(vi).
32. US: IRC sec. 59A(e)(3).

The Regulations, therefore, adopt the with-or-within method to determine the gross receipts and the base erosion percentage of an aggregate group.[33]In other words, for purposes of the calculation of the base erosion percentage, a taxpayer that is a member of an aggregate group measures the gross receipts and base erosion percentage of the aggregate group for a taxable year by reference to the taxpayer's gross receipts, base erosion tax benefits, and deductions for the taxable year and the gross receipts, base erosion tax benefits, and deductions of each member of the aggregate group for the taxable year of the member that ends with or within the taxpayer's taxable year.[34]

2.3. The BEAT Netting Rule

In determining the amount of the deduction that is used for purposes of the base erosion percentage test, the Regulations require the combination of all items of income, deduction, gain, or loss on each marked transaction for the year (the BEAT Netting Rule), such as from a payment, accrual, or mark.[35]The Preamble to the BEAT Regulations indicates that the BEAT Netting Rule was adopted to ensure that only a single deduction is claimed with respect to each marked transaction and 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.[36]

Section 1.59A-2(e)(3)(vi) of the Regulations applies to 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. The two primary reasons that a taxpayer would be subject to mark-to-market rules in the US tax system are if the taxpayer is a dealer in securities or commodities or the taxpayer holds certain contracts referred to as contracts under section 1256 of the Code.

Dealers in securities are required to carry any securities included in inventory at their fair market value.[37]In the case of any security which is not inventory in the hands of the dealer and which is held at the close of any taxable year, the dealer will recognize gain or loss as if such security were sold for its fair market value on the last business day of the taxable year, and any gain or loss is taken into account for such taxable year.[38]The gain or loss recognized is ordinary gain or loss.[39]

Section 475(c)(1) of the Code defines a dealer in securities as a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course or a trade or business or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For these purposes "security" includes, among other things, a note, bond, debenture or other evidence of indebtedness, and interest rate currency or equity notional principal contract.[40]

Section 1.475(c)-1(c)(1) of the Regulations provides that a taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business but engages in no more than negligible sales of securities is not a dealer within the meaning of section 475(c)(1) of the Code unless the taxpayer elects to be so treated or, for purposes of section 471 of the Code, the taxpayer accounts for any security as inventory. For these purposes, a taxpayer engages in negligible sales if the taxpayer sells all or part of fewer than 60 debt instruments in a taxable year or sells instruments with aggregate bases of less than 5% of the total bases of debt instruments that it acquires during a taxable year.[41]

A dealer in securities also includes a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing to enter into either side of interest rate, currency or equity notional principal contracts.[42]Except as to members of a consolidated group, transactions with related persons may be considered transactions with customers for the purposes of section 475 of the Code.[43]

Dealers in commodities may elect to apply the mark-to-market method in the same manner as a dealer in securities.[44]For these purposes, a commodity means any commodity that is actively trade and any swap, derivative instrument in, or any hedge against such a commodity.[45]Similarly, traders in securities and commodities may elect to apply the mark-to-market method.[46]

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33. US: Treas. Reg. sec. 1.59A-2(c)(3).
34. US: Treas. Reg. sec. 1.59A-2(c)(3).
35. US: Treas. Reg. sec. 1.59A-2(e)(3)(vi).
36. US: TD 9885 at 66971.
37. US: IRC sec. 475(a)(1).
38. US: IRC sec. 475(a)(2).
39. US: IRC sec. 475(d)(3).
40. US: IRC sec. 475(c)(2).
41. US: Treas. Reg. sec. 1.475(c)-1(c)(2).
42. US: Treas. Reg. sec. 1.475(c)-1(a)(2).
43. US: Treas. Reg. sec. 1.475(c)-1(a)(3)(i).
44. US: IR. sec. 475(e)(1).
45. US: IRC sec. 475(e)(2).
46. US: IRC sec. 475(f).

If a taxpayer is not a dealer or a trader, a taxpayer may still be subject to the mark-to-market method if the taxpayer holds contracts under section 1256 of the Code.

Section 1256 of the Code requires that any contract under section 1256 of the Code be marked to market.[47]Each contract under section 1256 of the Code is marked to market on the last business day of each taxable year, and any gain or loss is then taken into account. If a contract is subject to section 1256 of the Code, in general, 60% of the gain from the contract is capital gain and 40% of the gain on the contract is ordinary income without regard to the holding period on the contract.[48]A contract under section 1256 of the Code generally includes any regulated futures contract, any non-US currency contract, any non-equity option and any dealer equity option.

A regulated futures contract is defined as a contract (i) with respect to which the amount required to be deposited and the amount which may be withdrawn depend on a system of marking to market and (ii) which is traded on or subject to the rules of a qualified board or exchange.[49]

The term "non-US currency contract" means a contract which (i) requires delivery of, or the settlement of which depends on the value of, a non-US currency that is a currency in which positions are also traded through regulated futures contracts, (ii) is traded in the interbank market and (iii) is entered into at arm's length at a price determined by reference to the price in the interbank market.[50]

The term "non-equity option" means any listed option which is not an equity option.[51]A listed option is defined as any option (other than a right to acquire stock from the issuer) which is traded on (or subject to the rules of) a qualified board or exchange.[52]The term "equity option" means any option (i) to buy or sell stock; or (ii) the value of which is determined directly or indirectly by reference to any stock or any narrow-based security index.[53]

The term "dealer equity option" means, with respect to an options dealer, any listed option which (i) is an equity option; (ii) is purchased or granted by such options dealer in the normal course of its activity of dealing in options; and (iii) is listed on the qualified board or exchange on which such options dealer is registered.[54]

Thus, each of the definitions of a regulated futures contract, a foreign currency contract, any non-equity option and any dealer equity option turns in part on whether either the contract or the referenced property is traded on a qualified board or exchange.

Section 1.59A-3(b)(2)(iii) of the Regulations also applies the BEAT Netting Rule for purposes of determining the amount of base erosion payments that result from transactions that are marked to market.

3. The Treatment of Derivatives under the BEAT Regulations

3.1. Derivatives in general

Absent special treatment given to some derivatives, discussed below, or under the BEAT Netting Rule, discussed above, the analysis for derivatives is the same as for other payment obligations between a US presence and a non-US related party. In other words, the taxpayer must determine if all or some of the payments under the derivative are deductible for US tax purposes or whether they relate to an acquisition of property from a non-US related party. It should be noted, however, that the BEAT takes into consideration the gross payments made to the non-US related party. Some derivative contracts provide for some or all of the payments under the contract to be net-payment obligations. Except as provided in the BEAT Netting Rule or in regard to qualified derivative contracts, discussed below, taxpayers that are parties to such net-payment obligations will still need to look at the gross payment obligation in determining the level of the taxpayer's BEAT exposure.[55]For example, on a swap contract with a non-US related party, unless an exception applies, the US taxpayer would need to take gross payment obligations under the contract into consideration in making the BEAT calculations, even if the taxpayer is generally receiving net payments under the contract.

47. US: IRC sec. 1256(a)(1).
48. US: IRC sec. 1256(a)(3).
49. US: IRC sec. 1256(g)(1).
50. US: IRC sec. 1256(g)(2).
51. US: IRC sec. 1256(g)(3).
52. US: IRC sec. 1256(g)(5).
53. US: IRC sec. 1256(g)(6).
54. US: IRC sec. 1256(g)(4).
55. US: Treas. Reg. sec. 1.59A-3(b)(1).

3.2. Specific types of derivatives

3.2.1. Repos

Sale-repurchase transactions (REPOs) are used in a variety of contexts. Under US tax principles, a REPO is typically characterized as a collateralized loan where the purchaser of the underlying security is deemed to be a lender of funds to the seller in the amount of the purchase price.[56]The seller of the security is treated as the borrower. The loan is for the period until the REPO matures, when the securities are sold back to the original seller (i.e. the cash borrower). Typically, the repurchase price exceeds the original sales price, giving rise to a charge consisting of financing interest.

A derivative is generally defined in section 59A(h)(4) of the Code as any 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 listed items, including any share of stock in a corporation or any evidence of indebtedness. A derivative does not include any of the listed items. Section 59A(h)(4)(A)(ii) of the Code includes any evidence of indebtedness in the listed items.

Since a REPO satisfying certain conditions is treated as a secured loan for US federal tax purposes, it is not a derivative for the purposes of the BEAT.[57]

In general, section 163(a) of the Code allows as a deduction all interest paid or accrued within the taxable year on indebtedness. Section 163(j) of the Code limits the deduction of business interest expenses to the sum of (i) business interest income; (ii) 30% of the adjusted taxable income of the taxpayer for the taxable year; and (iii) the floor plan financing interest of the taxpayer for the taxable year.[58]The percentage of the adjusted taxable income is 50% for taxable years beginning in 2019 and 2020.[59]The amount of any business interest not allowed as a deduction for any taxable year may be carried forward beyond the year in which the business interest was paid or accrued, treating business interest as allowed as a deduction.[60]The limitation applies at the taxpayer level.

Since the BEAT is largely calculated based upon deductions allowed (or allowable), the BEAT calculation needs to be made after the disallowance rules of section 163(j) of the Code are applied. Where payments subject to the disallowance rules of section 163(j) are made both to related and unrelated persons, section 59A(c)(3) of the Code provides a stacking rule in cases in which section 163(j) of the Code applies to a taxpayer, under which the reduction in the amount of deductible interest under section 163(j) of the Code is treated as allocable first to interest paid or accrued to unrelated persons and then to related parties.

3.2.2. Securities lending transactions

Although economically similar to a REPO, securities lending transactions have historically been largely treated as a disposition followed by a repurchase.[61]Section 1058 of the Code provides a safe harbour to avoid gain recognition for the parties to a securities lending transaction.

The Regulations exclude a securities lending transaction from derivative treatment, in general, only if the securities lending transaction is treated as a secured loan for US federal income tax purposes.[62]The determination of whether a securities lending transaction or substantially similar transaction provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing takes into account arrangements that effectively serve as collateral due to the taxpayer's compliance with any US regulatory requirements governing such transaction.[63]

However, a derivative does not include the cash collateral component of a securities lending transaction (or the cash payments pursuant to a sale-repurchase transaction, or similar payments pursuant to a substantially similar transaction).[64]

Thus, the securities component of the securities lending transaction may be treated as derivative, but the cash component will often not be.

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56. US: *See* Rev. Rul. 74-27, 1974-1 CB 24; Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 79-108, 1979-1 CB 75; Rev. Rul. 79-195, 1979-1 CB 177. The US Supreme Court cited the IRS's position in US: USSC, 12 Dec. 1994, *Nebraska Dept. of Revenue v. Loewenstein* , 513 US 123, 128 n. 3 (1994), in holding that repos are collateralized lending agreements for purposes of characterizing payments with respect to such transactions for state tax purposes. *See also* US: CAFC, 4 Oct. 1972, *First American Nat'l Bank of Nashville v. United States* , 467 F.2d 1098 (6th Cir. 1972); US: CAFC, 4 May 1970, *Union Planters Nat'l Bank of Memphis v. United States* , 426 F.2d 115 (6th Cir.), cert. denied, 400 US 827 (1970); US: CAFC, 19 Jan. 1970, *American Nat'l Bank of Austin v. United States* , 421 F.2d 442 (5th Cir.), cert. denied, 400 US 819 (1970).
57. US: Treas. Reg. sec. 1.59A-6(d)(2)(iii)(A); REG-104259-18, 83 Fed. Reg. 65962 (21 Dec. 2018).
58. US: IRC § 163(j)(1).
59. US: IRC § 163(j)(10).
60. US: IRC § 163(j)(2).
61. US: USSC, 4 Jan. 1926, *Provost v. United States* , 269 U.S. 443 (1926).
62. US: Treas. Reg. sec. 1.59A-6(d)(iii)(2)(A).
63. US: Treas. Reg. sec. 1.59A-6(d)(iii)(2)(C).
64. US: Treas. Reg. sec. 1.59A-6(d)(iii)(2)(B).

3.2.3. Swaps

3.2.3.1. General treatment

Most swaps are treated as notional principal contracts (NPCs) for US tax purposes. An NPC for US tax purposes is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[65]NPCs include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps and similar agreements. Each confirmation under a master agreement to enter into NPC contracts is treated as a separate NPC contract for US tax purposes.[66]

The net income or net deduction from an NPC for a taxable year is included in or deducted from gross income for that taxable year. The net income or net deduction from an NPC for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year and all of the non-periodic payments that are recognized from that contract for the taxable year.[67]All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a non-periodic payment for the taxable year to which that portion relates.[68]

Under prior Regulations, when an NPC includes a "significant" non-periodic payment, the contract was generally treated as two separate transactions consisting of an on-market, level payment swap and a loan (the embedded loan rule).[69]

For US tax purposes, the payments on a swap that is treated as an NPC are generally deductible to the payer[70]and sourced based upon the residence of the payee.[71]This would mean that a swap between US and Dutch counterparties treated under the NPC rules would create a deductible payment in the United States, but the Dutch counterparty would not be subject to US tax, assuming the swap was not entered into in connection with a US trade or business with a permanent establishment.

3.2.3.2. Treatment under the BEAT Regulations

The BEAT Regulations make several modifications of the general treatment of swaps. First, the BEAT generally applies to gross payments on swaps.[72]As discussed above, the general treatment of a swap is for the net payment to be included in income or deductible. Second, swaps with significant non-periodic payments may be bifurcated into two instruments: an on-market swap and a debt instrument. The loan would be accounted for by the parties to the contract independently of the swap.[73]The time value component associated with the loan, determined in accordance with section 1.446-3(f)(2)(iii)(A) of the Regulations, would be recognized as interest expense to the payer and interest income to the recipient.

This second point in regard to significant non-periodic payments is not necessarily obvious from the face of the BEAT Regulations. However, "business interest expense" is defined under the BEAT Regulations by cross referencing section 1.163(j)-1(b)(2) of the Regulations. Section 1.163(j)-1(b)(2) does not currently exist in final Regulations as of the time of this writing. However, section 1.163(j)-1(b)(2) is the definition of "business interest expense" in proposed Regulations. In those proposed Regulations, "interest" is defined to include the time value of the money component in a swap with a significant non-periodic payment other than a cleared swap.[74]The term "cleared swap" means a swap that is cleared by a derivatives clearing organization, as such term is defined in section 1a of the US Commodity Exchange Act,[75]or by a clearing agency, as such term is defined in section 3 of the US Securities Exchange Act of 1934,[76]that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the US Securities Exchange Act of 1934, respectively, if the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral.[77]

Thus, the definition of "business interest expense" in the BEAT Regulations would include the time value of the money component in a swap with a significant non-periodic payment other than a cleared swap.

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65. US: Treas. Reg. sec. 1.446-3(c)(1)(i).
66. US: Treas. Reg. sec. 1.446-3(c)(1)(i).
67. US: Treas. Reg. sec. 1.446-3(d).
68. US: Treas. Reg. sec. 1.446-3(e)(2)(i).
69. US: Treas. Reg. sec. 1.446-3(g)(4), before amendment by TD 9719, 80 FR 26437, as corrected by 80 FR 61308 (13 Oct. 2015).
70. US: FSA 1998-124 (3 Aug. 1993).
71. Treas. Reg. sec. 1.863-7(b)(1).
72. US: Treas. Reg. sec. 1.59A-3(b)(1).
73. REG-106089-18, 83 Fed. Reg. 67490, 67494 (28 Dec. 2018).
74. US: Prop. Reg. sec. 1.163(j)-1(b)(20)(ii)(A).
75. US: 7 USC 1a.
76. US: 15 USC 78c.
77. US: Prop. Reg. sec. 1.163(j)-1(b)(5).

3.3. Qualified derivative payments

Section 59A(h)(1) provides that a qualified derivative payment is not treated as a base erosion payment. To qualify for the qualified derivative payment exception, the payment must be made with respect to a derivative. “Derivative” is generally defined in section 59A(h)(4) of the Code as any 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 listed items, including any share of stock in a corporation, any evidence of indebtedness, any commodity that is actively traded, any currency, or any rate, price, amount, index, formula or algorithm. A derivative does not include any of the listed items upon which the value of a derivative may be based.

So for example, an instrument whose value is determined by reference to a debt instrument may be derivative, but an instrument that is treated as a debt instrument would not be.

Section 1.59A-6(b) of the Regulations defines “qualified derivative payment” as a payment made by a taxpayer to a non-US 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 Code or the taxpayer’s method of accounting); (ii) treats any recognized gain or loss 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. This definition would mean that payments in respect of derivatives subject to the mark-to-mark method under section 475 of the Code would be eligible to be qualified derivative payments, but payments in respect of derivatives subject to the mark-to-market method under 1256 of the Code would not be. This distinction arises because section 475 of the Code treats mark-to-market gains as ordinary, but section 1256 of the Code treats mark-to-market gains as capital. Since the second prong of the qualified derivative payment requirements is ordinary treatment, contracts under section 1256 of the Code would be excluded.

Section 59A(h)(3) of the Code excludes from the qualified derivative payment exception any payment that would be treated as a base erosion payment if it were not made pursuant to a derivative (such as interest, royalty, or service payments). Section 59A(h)(3) also excludes any payment properly allocable to a non-derivative component of a contract that contains derivative and non-derivative components.

No payment is a qualified derivative payment for any taxable year unless the taxpayer (whether or not the taxpayer is otherwise a reporting corporation as defined in section 1.6038A-1(c) of the Regulations) reports the information required in section 1.6038A-2(b)(7)(ix) of the Regulations for the taxable year. Under section 1.6038A-1(c) of the Regulations, a reporting corporation is a US corporation that has at least one 25% non-US shareholder or a non-US corporation that is engaged in a US trade or business and has at least one 25% non-US shareholder. To report its qualified derivative payments, a taxpayer must include the payment in the aggregate amount of qualified derivative payments on Form 8991 (or any successor form).[78]

If any reporting corporation meets both the USD 500 million gross receipts and base erosion percentage thresholds, discussed above, it must report the information required by Form 8991 and by any Form 5472 it is required to file (including the information required by their accompanying instructions), regarding:

- the determination of whether the taxpayer is an applicable taxpayer;
- computation of the base erosion minimum tax amount, including computation of regular tax liability as adjusted for purposes of computing base erosion minimum tax amount;
- computation of the modified taxable income;
- the base erosion tax benefits;
- the base erosion percentage calculation;
- the base erosion payments;
- amounts with respect to services as described in services 1.59A-3(b)(3)(i) of the Regulations, including a breakdown of the amount of the total services cost and any markup component;
- arrangements or transactions described in the anti-abuse and recharacterization rules;
- any qualified derivative payment, including (i) the aggregate amount of qualified derivative payments for the taxable year; and (ii) a representation that all payments satisfy the requirements of section 1.59A-6(b)(2) of the Regulations; and
- any other information necessary to carry out section 59A of the Code.[79]

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78. US: Treas. Reg. sec. 1.59A-6(b)(2).
79. US: Treas. Reg. sec. 1.6038A-2(b)(7).

4. Conclusion

The structure of the calculations for the BEAT will require detailed modelling for the most accurate planning. However, the importance of the base erosion percentage in the calculation suggests focus on what is contained in the numerator and denominator of that threshold equation. For example, for a taxpayer on the border of the 2 or 3% threshold, refinancing related-party debt with third-party debt would remove the interest from the numerator without affecting the denominator. Similarly, applying the mark-to-market method under section 475 of the Code would potentially make derivatives eligible for qualified derivative payment treatment and, with respect of corporate taxpayer, without affecting the regular tax rate applicable.

The overall impact of the BEAT will necessarily need to be determined over time as other jurisdictions consider or adopt similar tax provisions, including those based upon the global anti-base erosion (GloBE) proposal included in the OECD's *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* .[80]However, both under BEAT and GloBE, a premium has been put on the use of sophisticated modelling before any deductible related-party transaction is put in place.

80. OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* , OECD/G20 Inclusive Framework on BEPS (OECD 2019), available at www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm ("Programme of Work") (accessed 9 June 2020).