BEAT

Can't Find the BEAT: The Interaction of the New Base Erosion Rules With a Foreign Bank's branch interest Deductions

It is clear that the BEAT applies to a foreign bank's interest expense deduction to the extent that such interest is treated as paid or accrued to a foreign related party. It is not certain, however, to what extent interest expense allocated to the foreign bank's U.S. trade or business under Treasury Regulations or an applicable treaty should be treated as paid or accrued to a foreign related party for purposes of the BEAT.

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The 2017 Tax Cuts and Jobs Act ((P.L. 115-97, December 22, 2017) added the base erosion anti-abuse tax (commonly known as the "BEAT") (**Section 59A** , "Tax on base erosion payments of taxpayers with substantial gross receipts"). The BEAT follows a Senate proposal, and adds back to taxable income most expenses paid or accrued by U.S. corporations and U.S. branches of non-U.S. corporations to foreign related parties **1** for which a current deduction is claimed. If the result ("modified taxable income") multiplied by the applicable tax rate **2** exceeds the regular tax liability, the corporation pays the BEAT in lieu of its regular tax liability.

Foreign banks doing business in the U.S. are finding it pretty rough to keep time to the BEAT. It is clear that the BEAT applies to a foreign bank's interest expense deduction to the extent that such interest is treated as paid or accrued to a foreign related party. It is not certain, however, to what extent interest expense allocated to the foreign bank's U.S. trade or business under Treasury Regulations **3** or an applicable treaty should be treated as paid or accrued to a foreign related party for purposes of the

BEAT. As discussed below, the authors believe that under existing law in the absence of guidance, the BEAT should not apply to interested allocated to the foreign bank's U.S. trade or business in excess of the interest actually paid by its U.S. branch **4** but recommend that non-U.S. banks proceed with caution as the law in this area continues to evolve. **4.1**

Background: Brief Overview of Reg. 1.882-5

Under **Reg. 1.882-5** , the deductible interest expense of the U.S. trade of business of a foreign bank is determined under a formula. **5** Conceptually, the formula is based on the premise that the amount of liabilities considered attributable to the U.S. trade or business should be determined by the amount of average assets attributed to the U.S. trade or business, rather than the actual amount of liabilities booked in the U.S. branch. Accordingly, the bank's average "U.S. assets" **6** for the year are multiplied by either a fixed ratio of 95% or the actual ratio of worldwide assets to worldwide liabilities to arrive at its (deemed) "U.S. connected liabilities" (USCLs). **7** Interest expense on USCLs is calculated by applying a rate (determined under either of two methods-the adjusted U.S. book liability (AUSBL) or the separate currency pools (SCP) method) to USCLs. **8** Under the AUSBL method (SCP is discussed below), calculation of the rate depends on whether USCLs exceed U.S. booked Liabilities, which are liabilities on the books of the U.S. branch (other than liabilities with other branches). **9** Under the AUSBL, if:

- USCLs exceed U.S. book liabilities, **10** allocable interest is determined by adding the interest expense on U.S. book liabilities (generally "branch interest") to the interest expense on excess liabilities (i.e., USCLs in excess of U.S. book liabilities). The interest expense on excess liabilities is calculated by applying a rate based (by annual election) of either (1) 30-day LIBOR; or (2) the bank's cost of borrowing U.S. dollars (USD) outside the U.S., which is determined by dividing the bank's interest expense on USD liabilities outside the U.S. by its average USD liabilities outside the U.S. **11**
- USCLs are less than U.S. booked liabilities, allocable interest is determined by scaling down the interest expense on U.S. booked liabilities by the ratio of USCLs to U.S. booked liabilities (i.e., allocable interest = interest expense on U.S. booked liabilities × USCL/U.S. booked liabilities). **12**

The operation of these provisions can be illustrated by the following examples.

Example 1. U.S. branch has less booked liabilities than the branch assets can support:

- $1,000M in USCLs.
- $800M in U.S. booked liabilities.
- $200M excess liabilities ($1,000M - $800M).
- Assuming a 1% rate on U.S. booked liabilities = $8M ($800M × 1%) in interest.
- Assuming a 1.5% rate on all USD liabilities outside the U.S.

Allocable interest under **Reg. 1.882-5** = $8M on U.S. book liabilities + $3M on excess liabilities ($200M × 1.5%) = $11M.

Example 2. U.S. branch has more liabilities booked in the U.S. than U.S. assets can support. Same as Example 1 except:

- $600M in USCLs.
- $800M in U.S. book liabilities.

Allocable interest under Reg. 1.882-5 = $8M on book liabilities × ($600M USCL/$800M U.S. book liabilities) = $6M.

As can readily be seen by these examples, the amount of liabilities, and the amount of interest expense, when the interest deduction is determined under **Reg. 1.882-5** , is based on a formula, not the actual liabilities on the books of the U.S. branch. As will be seen below, the BEAT assumes that the creditor can be readily ascertained for the purpose of determining the interest deductions that will be added back to income. No guidance whatsoever has been promulgated to make this determination when interest expense is determined by a formula.

BEAT and Reg. 1.882-5

The lack of statutory guidance and in the legislative history on the interaction of the BEAT and the formulary interest deduction gives rise to several issues. In attempt to navigate the interaction of the BEAT and the existing rules, the discussion below will address the following questions:

- What portion of branch interest should be treated as BEAT payment?
- What portion of excess interest (all or a proportionate amount) should be treated as a BEAT payment?
- How might the SCP method and the notion of fungibility affect the treatment of the **Reg. 1.882-5** allocation for BEAT purposes?
- How should a bank in a scale-down situation be treated for BEAT purposes?

BEAT and the Authorized OECD Approach

Certain U.S. income tax treaties permit foreign banks to elect to determine the attribution of profits, including the allocation of interest expense, using an Authorized OECD Approach (AOA). [13] The AOA recognizes interbranch transactions, i.e., internal dealings between the U.S. branch and other (particularly foreign) branches of the bank. This article considers the impact of the application of the AOA to the application of BEAT, addressing the following questions:

- What is the impact of the AOA on BEAT, particularly the recognition (for transfer pricing purposes) of internal dealings?
- What is the broader impact of the AOA on BEAT?

Analysis

Section 884(f) 14 provides the most comprehensive guidance on the treatment of interest expense allocated to a foreign bank's U.S. trade or business. In general, **Section 884(f)** provides that interest paid by a U.S. branch attributable to its U.S. trade or business activities (i.e., its branch interest) is treated as though it were paid by a U.S. corporation. **15** If the U.S. branch's allocated interest (i.e., its **Reg. 1.882-5** deduction) is in excess of such amount, the excess (i.e., its excess interest) is treated for certain purposes as though paid by a U.S. corporation to the foreign corporation. **16** Applying these provisions to the **Reg. 1.882-5** calculations in Examples 1 and 2 above:

- **Section 884(f)(1)(A)** -applies to branch interest paid on U.S. book liabilities ($8M in Example 1).
- **Section 884(f)(1)(B)** -applies to excess interest ($3M in Example 1).
- **Section 884(f)(2)** -applies to the Reg. 1.882-5 deduction ($11M in Example 1; $6M in Example 2).
- **Section 884(f)(1)(B)** flush language-applies to scaled-down interest ($2M ($8M-$6M) in Example 2).

Application of BEAT to Reg. 1.882-5 amounts.

Branch interest. First, consider the situation where the U.S. branch makes a direct payment of interest to a foreign related party.

Example 3. Same as Example 1 but $100M of the $800M in U.S. book liabilities is liabilities with foreign related parties.

Q: *What portion of branch interest should be treated as a BEAT payment?*

Reg. 1.884-4(b) defines branch interest as "interest that is ... paid by a foreign corporation with respect to a liability that is ... a U.S. booked liability within the meaning of [Reg.] 1.882-5(d)(2)...." In addition, **Reg. 1.884-4(a)(1)** provides:

> *..."branch interest"...shall, for purposes of subtitle A (Income Taxes), be treated as if it were paid by a domestic corporation....*Such interest shall be subject to tax under section 871(a) or 881, and to withholding under section 1441 or 1442, in the same manner as interest paid by a domestic corporation if received by a foreign person and not effectively connected with the conduct by the foreign person of a trade or business in the United States. (Emphasis added.)

This provision is consistent with the **Section 884(f)(1)(A)** language that "*any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation."* **Regs. 1.884-4(a)(1)** and (b) make it clear that **Section 884(f)(1)(A)** is meant to apply to interest paid on U.S. liabilities (subject to the scale-down discussed below), i.e., branch interest, and that branch interest is treated as paid by a domestic corporation for all "purposes of subtitle A (Income Taxes)."

In Example 3: 1% × $100M = $1M BEAT payment subject to add-back.

Authors' perspective. All branch interest paid to foreign related parties for which a **Reg. 1.882-5** interest expense deduction is allowed should be treated as a BEAT payment, i.e., treated as paid by a domestic corporation to a foreign related party. It also follows that to the extent that the **Reg. 1.882-5** deduction is attributed to branch interest not paid to a foreign related party, it should not be treated as a BEAT amount.

Excess interest.

Q: *Should all excess interest be treated as a BEAT payment?*

Specifically, the issue can be framed as whether excess interest, which is treated as interest paid by a wholly owned domestic corporation to its foreign parent, i.e., to the head office branch, for purposes of **Section 881** in applying the branch level interest tax (BLIT), should be treated similarly for BEAT purposes. In general, excess interest is defined as the amount of interest allocated under **Reg. 1.882-5** for the tax year minus the foreign corporation's branch interest on U.S. booked liabilities. **17** The BLIT is imposed in accordance with **Section 884(f)(1)(B)** , which provides "to the extent that the allocable interest exceeds the interest [paid by the U.S. branch, i.e., branch interest], such foreign corporation shall be liable for tax under section 881(a) in the same manner as if such excess were interest paid to such foreign corporation by a wholly owned domestic corporation."

In this regard, **Reg. 1.884-4(a)(2)** provides:

(ii) A foreign corporation shall be liable for tax on excess interest under section 881(a) in the same manner as if such excess interest were interest paid to the foreign corporation by a wholly-owned domestic corporation....Excess interest shall be exempt from tax under section 881(a) only as provided in paragraph (a)(2)(iii) of this section (relating to treatment of certain excess interest of banks as interest on deposits) or paragraph (c)(3) of this section (relating to income tax treaties).

> (iv)...and shall not be subject to withholding under section 1441 or 1442.

Together, these sections mandate that excess interest should be treated as paid by a wholly owned domestic corporation to its foreign parent for the specific purpose of imposing a tax under **Section 881** (i.e., BLIT). This treatment is distinguishable from the comprehensive treatment of branch interest, which is deemed to be paid by a domestic corporation for all regular income tax purposes. Thus, it would appear that these provisions should not be read to treat excess interest as paid by a wholly owned subsidiary to a foreign parent for other purposes when not provided specifically.

Our reading is supported by the Regulations promulgated under the excess interest rules of **Section 163(j)** . Specifically, the IRS extended the treatment of excess interest as paid by a U.S. corporation to a foreign corporation to the application of the earnings-stripping provisions through Proposed Regulations. **18 Proposed Reg. 1.163(j)-8(d)** provides:

> For purposes of this section, the amount of interest that is paid, or deemed paid, by a foreign corporation to a related person, as defined in [Reg.] 1.163(j)-2(g), shall equal the sum of the amount of interest paid by a U.S. trade or business of the foreign corporation under section 884(f)(1)(A) to a person that is related to the foreign corporation *and the amount of interest described in section 884(f)(1)(B) ("excess interest"* within the meaning of [Temp. Reg.] 1.884-4T(a)). (Emphasis added.)

In this instance, however, Treasury was provided specific authority to issue Regulations concerning the interplay between **Section 163(j)** and **Section 884** . The Committee Reports **19** for **Section 163(j)** specify:

> In the case of a foreign corporation, which is engaged in trade or business within the United States, that pays interest to a related party that is tax exempt with respect to such interest payments, the determinations under the bill of disqualified interest, adjusted taxable income, and net interest expense would take into account only income that is effectively connected with the U.S. trade or business and deductions allocable thereto. In addition, in such cases the provisions of the bill may need to be modified in their interaction with the tax treatment of U.S. branches under section 884. Accordingly, the bill authorizes the Secretary to issue such regulations as are necessary to conform the operation of the branch profits tax and the branch-level tax on interest to the tax treatment provided under the bill. *The committee anticipates that such regulations will (1) treat the tax on interest under section 884(f)(1)(B) as imposed on the recipient for the purpose of determining whether the recipient is tax exempt*. (Emphasis added.)

In addition to the BLIT and the earnings-stripping rules, another area where a U.S. branch's foreign related-party interest payments are at issue is **Section 267** . **Reg. 1.267(a)-3(b)** provides:

> An amount that is owed to a related foreign person and that is otherwise deductible...may not be deducted by the taxpayer until such amount is paid to the related foreign person.... *An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 884(f)).* (Emphasis added.)

This section limits the application of the related-party payment deferral rules **Reg. 1.267(a)-3** to branch interest, which is treated as paid by a wholly owned domestic corporation. Excess interest is treated as paid by a wholly owned domestic corporation to its foreign parent for purposes of **Section 881** under **Reg. 1.884-4(a)(2)(iii)** and **Section 884(f)(1)(B)** but expressly not for purposes of **Sections 1441** and **1442** (as per **Reg. 1.884-4(a)(2)(iv)**). Accordingly, it was not the legislators' intent to treat excess interest as being paid by a domestic subsidiary to its foreign parent for withholding tax purposes.

Conceptually, there is no reason to apply **Reg. 1.267(a)-3** to excess interest. The purpose of the rule is

to defer a deduction when a payment to a foreign affiliate that would be subject to **Sections 1441** and **1442** withholding has not been made. The BLIT on excess interest is not dependent on a payment (i.e., it is deemed paid). Nevertheless, it is instructive to compare the **Section 163(j)** and **Section 267** Regulations to the BEAT provisions under **Section 59A** to assess the legislative intent in this area. **Section 59A(c)(2)** provides an exemption for BEAT payments subject to withholding:

> ...[A]ny base erosion tax benefit attributable to any base erosion payment-
>
> (I) on which tax is imposed by section 871 or 881, and
>
> (II) with respect to which tax has been deducted and withheld under section 1441 or 1442,
>
> shall not be taken into account in computing modified taxable income.

As discussed, excess interest is not subject to **Section 1441** (only **Section 881**), so this exemption as drafted should not apply to excess interest, even though such excess interest may be subject to tax under the BLIT. The drafting supports the conclusion that Congress did not intend, or at least not contemplate, the application of BEAT to excess interest. That is, unless one believes that it was the intent of Congress that a foreign bank from a non-treaty jurisdiction (or a treaty jurisdiction that does not exempt interest) be subject to a 30% (or treaty rate) gross basis BLIT on all of its excess interest and also be subject to the BEAT on the full amount.

This brings us to the question of whether Treasury could, or should, issue Regulations in this scenario to treat excess interest as an add-back in deriving modified taxable income. The Proposed Regulations under **Section 163(j)** demonstrate a proposed extension of the "paid by to foreign corporation" treatment of excess interest to the earnings-stripping area, which, like BEAT, is also a base erosion concept. However, these Proposed Regulations were promulgated pursuant to a legislative mandate. No such specific grant of authority is apparent in the BEAT provisions or legislative history.

The BEAT provisions grant Treasury authority to issue anti-avoidance Regulations under **Section 59A** . This grant of authority should not extend to allow Treasury to write interpretative Regulations to this effect. Courts view interpretative Regulations as limited. Under **Section 7805(a)** , the IRS's authority to issue Regulations is not the power to make law but to carry into effect the will of Congress as expressed in the statute under which the Regulations are prescribed. **20**

It is not clear to what extent Treasury could use anti-avoidance Regulations to incorporate the BLIT fiction to find a related-party payment under the BEAT rules. It would seem that given (1) the limitation on the extent to which excess interest is treated as paid by a domestic subsidiary to its foreign parent in **Section 884(f)** (i.e., for **Section 881** purposes only, compared with the more comprehensive treatment of branch interest); and (2) that when Congress wanted to expand the fiction, it provided for it specifically in the **Section 163(j)** legislation (in contrast to the absence of such mandate in **Section 59A** and the

limitation of the **Section 59A(i)** exemption), the better view, especially under current law, would seem to be that excess interest should not be treated as paid by a wholly owned domestic corporation to its foreign parent for BEAT purposes.

One final distinction that is worth noting is that the BLIT is meant to function as a surrogate for the withholding tax imposed under **Sections 1441** and 1442 on U.S.-source payments to foreign parties. This may be said to be a reasonable approach since the interest expense of the bank s foreign branches is generally paid to lenders outside the U.S. (i.e., foreign recipients that would be subject to withholding tax on direct payments). However, such payees are very often not related parties. Accordingly, the BLIT fiction would not be a good surrogate for the BEAT amount.

In Example 3: 3M (1.5% on $200M) should not be BEAT (under current **Section 59A**).

Authors' perspective. Excess interest should not be treated as interest paid by a wholly owned domestic corporation to its foreign parent, as it is for BLIT purposes, under existing law. It is not entirely clear, however, to what extent Treasury would have the authority to write Regulations to this effect.

Q: *Should a portion of excess interest be treated as a BEAT payment?*

If excess interest should not be treated as a BEAT payment in its entirety even though it is treated as paid by a wholly owned domestic corporation to its foreign parent for other limited purposes, the question remains whether a portion of the excess interest that can be traced to amounts allocated from branches outside the U.S. that was paid on liabilities with foreign related parties should be treated as a BEAT payment. Certainly, equity suggests that to the extent that the payment is subject to the BLIT, it should not also be subject to the BEAT.

Example 4. Same as Example 3 but there is $1,000M in total USD liabilities outside the U.S. ($15M in interest ($1,000M × 1.5%)). Of this amount, $200M (3M in interest ($200M × 1.5%) is with foreign related parties.

Reg. 1.882-5 provides that the "applicable interest rate" on excess U.S.-connected liabilities is determined by dividing the total interest expense paid or accrued for the tax year on U.S.-dollar liabilities that are not U.S.-booked liabilities and that are shown on the books of the offices or branches of the foreign corporation outside the United States by the average U.S.-dollar denominated liabilities (whether interest-bearing or not) that are not U.S.-booked liabilities and that are shown on the books of the offices or branches of the foreign corporation outside the United States for the tax year. Thus, the **Reg. 1.882-5** provisions, by their terms, apply to determine the "applicable rate" to be applied to excess liabilities, rather than to allocate interest expense incurred in regard to any particular liability (e.g., the way that Reg. 1.861-8 does in regard to general and administrative expenses). Moreover, that applicable rate is applied to excess USCLs, which are merely deemed liabilities. An additional argument in support of this perspective is the election to use a LIBOR rate, which is a rate index that is not tied in any way to particular liabilities of the bank. Arguably, therefore, these rules operate to provide a "benchmark rate," much like the transfer pricing provisions that are based on the determination of a comparable rate.

There are arguments on the other side. For example, **Reg. 1.882-5(a)(3)** limits the deductible interest expense under **Reg. 1.882-5** to the total interest on indebtedness paid or accrued by the taxpayer. This arguably implies that perhaps the **Reg. 1.882-5** regime is an actual allocation of worldwide interest, since there must exist sufficient interest expense in the entity to be allocated under the Regulation. Further, it can be argued that the election to use the 30-day LIBOR rate was provided to banks as a matter of administrative convenience and the Regulations do in fact reference the actual liabilities on the books of the bank outside the U.S. in determining the rate. Nevertheless, without authoritative guidance on point, conceptual arguments such as these should not constitute an authoritative basis on which a taxpayer should be considered to have made a BEAT payment by applying an applicable rate to deemed liabilities.

Moreover, it is an established legislative principle that if the applicable tax law does not provide definitive guidance in an area, or if the guidance provided is ambiguous, any reasonable method employed by the taxpayer should be respected. **21** Here, no guidance has been provided regarding how a foreign bank might allocate, or trace, a portion of its excess interest to BEAT payments. Indeed, the exemption under **Section 59A(c)(2)** does not even seem to contemplate the excess interest as components of the BEAT regime. Given that the BEAT regime is based on the newly developed concept of modified taxable income, **22** it would seem particularly reasonable to expect that any such modifications to taxable income (i.e., BEAT amounts) be defined clearly in the tax law. Thus, absent guidance to the contrary and considering the arguments discussed herein, it would appear that a foreign bank should not be required to treat a portion of its excess interest as a BEAT payment under the current provisions.

In addition, for various business and regulatory reasons, many foreign banks fund their operations through foreign affiliates. For example, a foreign bank may fund its worldwide operations through a centralized treasury function. In fact, some jurisdictions require that certain long-term debt be issued from a top-tier holding company or an affiliated corporation. Other jurisdictions may require a separate deposit-raising entity by home-country regulation. In certain cases, circular cash flows may be created because a subsidiary may need long-term funding to meet liquidity requirements, the cash proceeds from which it may deposit back into the bank. The treatment of gross amounts as BEAT add-back payments by application of a tracing approach under the BEAT provisions could have a devastating effect on such foreign bank's tax posture and its ability to do business in the U.S. Accordingly, it would seem that any Regulations that require tracing would need to take such regulatory funding requirement into account (e.g., by way of an exemption for such amounts).

Further, interest expense paid to the U.S. branch by a bank's U.S. subsidiaries, including for example its U.S. broker-dealer, is apparently treated as a BEAT payment to its U.S. subsidiary, even if the interest income is effectively connected with the bank's U.S. trade or business, since no exemption for effectively connected income is provided under the BEAT provisions for payments to foreign related parties (i.e., the bank is a foreign corporation notwithstanding that the payment is made to its U.S. branch). Thus, a bank that borrows worldwide from foreign affiliates and funds its U.S. group through its U.S. branch could (if a tracing approach were applied) find itself in a situation where (1) its U.S. subsidiary has a

BEAT add-back payment for interest paid to the U.S. branch; (2) its U.S. branch is subject to tax on the effectively connected interest income from its U.S. subsidiary; (3) its U.S. branch is subject to BEAT on a portion of its excess interest that is deemed to be paid or accrued on liabilities to foreign affiliates that are funding the U.S. subsidiary loan; and (4) depending on the treaty jurisdiction, its U.S. branch is subject to the BLIT on the excess interest.

Ultimately, a foreign bank should be alert for guidance that may be forthcoming in this area. Such guidance may include the treatment of a ratable portion of related-party excess interest as a BEAT payment. Nevertheless, in the authors' view, such approach should provide for an exemption from BEAT to the extent that (1) BLIT is imposed on the amount; and (2) the amount is paid on related-party funding for regulatory purposes.

In Example 4: 20% ($200M/$1,000M) of the $3M in excess interest = $600K, which is arguably not BEAT under current law but may ultimately be treated as BEAT (with certain exceptions). **23**

Authors' perspective. A foreign bank should be able to take the position under current law that none of the excess interest should be treated as BEAT. A foreign bank should be mindful, however, that the law in this area is not yet defined.

Separate Currency Pools

Q: *How might a separate currency pool approach and the notion of fungibility affect the treatment of Reg. 1.882-5 allocation for BEAT purposes?*

Under the SCP method, a blended rate is used based on the cost of borrowing worldwide liabilities (i.e., both U.S. branch and foreign branch) liabilities for each currency pool that in which the U.S. assets are denominated. Applying SCP, in Example 4: Rate = ($8M + $15M)/($800M +$1,000M) = 1.25% (rounded), resulting in $12.5M in interest expenses on $1,000M in USCLs (i.e., $8M branch interest and $4.5M excess interest).

It might be suggested that this blended or fungibility approach could also be applied to allocate the related-party liabilities for BEAT purposes. In other words, applying this approach, a bank's **Reg. 1.882-5** allocable interest expense might be prorated between BEAT and non-BEAT payments based on a foreign bank's worldwide foreign related-party liabilities (in the relevant currency pools) divided by its total worldwide liabilities (in those pools). While this approach may seem economically appealing, there are several problems with it.

First, it could result in more interest expense being added to modified taxable income than there is excess interest plus branch interest paid to foreign related parties combined. This would mean that a portion of the branch interest that was not paid to foreign related parties would have to be treated as paid to a foreign related party, which is contrary to **Section 884(f)(1)(A)** .

For instance, in Example 4, if $800M (instead of $200M) of the USD liabilities outside the U.S. (and $100M inside the U.S.) were liabilities to foreign related parties, 50% ($900M/$1,800M) of the $12.5M interest = $6.5M (rounded for purposes of illustration) would be treated as a BEAT payment, which is more than the $4.5M in excess interest and the $1M in branch interest actually paid to foreign related parties. This would mean that $1M of additional branch interest that is not paid to foreign related parties would have to be treated as a BEAT payment. However, if it were not paid to a foreign related party, under **Section 884(f)(1)(A)** , it should be treated as paid by a domestic corporation to other than a foreign related party and, thus, cannot be a BEAT payment. Moreover, the converse is also possible-when the foreign bank has significant foreign related-party borrowings inside but not outside the U.S., a portion of the branch interest that is paid to a foreign related party would, under this approach, not be treated as a BEAT payment contrary to **Section 884(f)(1)(A)** .

Second, the methodology used would seemingly need to be consistent whether the bank used the AUSBL or SCP method. However, many banks use AUSBL with LIBOR because they cannot readily compile the information to calculate their worldwide cost of borrowing. This approach would seem unduly burdensome in this instance. Further, the bank may be in a scale-down situation under AUSBL and may not otherwise need to calculate its worldwide cost of borrowing. The distortive effects discussed in the prior paragraph would occur virtually anytime that the bank is in a scale-down situation under this approach (i.e., as it would have no excess interest and only branch interest to allocate to BEAT).

Authors' perspective. SCP and the notion of fungibility should probably not affect the determination of BEAT (whether the bank is using the SCP or AUSBL method).

Scale-down.

Q:*How should a bank in a scale-down situation be treated for BEAT purposes?*

Example 5. Same as Example 2 but $100M of the $800M in U.S. book liabilities is to foreign related parties.

When a bank is in a scale-down situation (i.e., interest expenses on U.S. book liabilities > allocated interest under Reg. 1.882-5), it has no excess interest. Thus, all of its allocable interest expense is from branch interest. Accordingly, the determination of its BEAT payments is based entirely on its branch interest, which is treated as paid by a domestic corporation under **Section 884(f)(1)(A)** .

A bank that is in a scale-down position has the option of identifying which of its U.S. book liabilities give rise to branch interest and which do not (in accordance with the flush language of **Section 884(f)(1)(B)**). **Reg. 1.884-4(b)(6)** allows a foreign bank to identify specifically which of its liabilities give rise to branch interest. **24**

Accordingly, in Example 5, when the bank has $600M in USCL ($6M allocable interest) and $800M in U.S. book liabilities ($6M branch interest), it is in a $200M liability ($2M interest) scale-down position. It

can designate all of its $100M in foreign related-party liabilities, which carry 1M of "BEAT interest" (along with $100M in other liabilities) as not giving rise to branch interest. If it does so, it should have no BEAT payments (i.e., in this example), since all of its branch interest should be treated as paid by a domestic corporation to other than a foreign related party.

Authors' perspective. When a bank is in a scale-down situation, the determination of its BEAT payments is based entirely on its branch interest, which is treated as paid by a domestic corporation. Further, a bank in a scale-down position should be able to identify (to the extent provided in the Regulations) which of its U.S. book liabilities give rise to branch interest and which do not.

Application of BEAT to AOA.

Q: *What is the impact of the AOA on BEAT in particular the recognition of internal dealings?*

As noted above, the applicable taxpayer for BEAT purposes is the corporation, i.e., the foreign bank (in and outside the U.S.) under **Section 59A(e)** , not just the U.S. branch. Accordingly, transactions between branches of the foreign corporation (interbanch transactions) are ignored. The AOA applies an alternative **25** transfer pricing methodology to the attribution of profits to permanent establishments (PEs) of a foreign bank **26** in accordance with Article 7 (Business Profits) of an applicable income tax treaty as if it were a "*separate and independent enterprise."* However, it *"does not* create *legal obligations or other tax consequences that would result from transactions having independent legal significance."* **27** That is to say, nothing in the AOA would affect the established principle that a " *taxpayer cannot enter into a contract with itself."* **28**

Article 7(2) of the U.S. Model Tax Convention, for example, says:

> [T]he *profits that are attributable in each Contracting State to the permanent establishment* referred to in paragraph 1 of this Article are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, *if it were a separate and independent enterprise* engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. (Emphasis added.)

29

A plain reading of this language indicates that a PE should be treated as a separate and independent enterprise, similar, for example, to an incorporated subsidiary, **30** but only for the purpose of profit attribution. **31** In accordance with Article 7, the AOA treats the PE as a separate entity solely for purposes of determining an appropriate profits attribution. The OECD 2010 Report on the Attribution of Profits to Permanent Establishments ("OECD Report") makes this very clear:

> *The hypothesis by which a PE is treated as a functionally separate and independent enterprise is a mere fiction necessary for purposes of determining the business profits of this part of the enterprise under Article 7. The authorised OECD approach should not be viewed as implying that the PE must be treated as a separate enterprise entering into dealings with the rest of the enterprise* of which it is a part for purposes of any other provisions of the Convention. [Emphasis added]. **32**

In this regard, the AOA acknowledges the legal and factual distinctions between a PE and a truly separate entity. The OECD Report says:

> ...the authorised OECD approach is to apply the guidance given in the Guidelines not directly but by analogy. This Report discusses how and to what extent the guidance in the Guidelines can be applied, by analogy, to attribute profits to a PE and how to adapt and supplement that guidance to take into account factual differences between a PE and a legally separate enterprise. In this context, it should be noted that the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. **33**

Accordingly, under the AOA transfer pricing methodology, the "recognition" of internal dealings serves to provide a reference for profits attribution. It does not affect the treatment of internal dealings for other purposes and specifically not for tax. The U.S. Treasury Technical Explanation to the 2006 U.S. Model Tax Convention states expressly:

> [A]ny of the methods used in the Transfer Pricing Guidelines, including profits methods, may be used as appropriate and in accordance with the Transfer Pricing Guidelines. However, the use of the *Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance.* (Emphasis added.)

34

This precise point is reiterated throughout the OECD Report. For example:

> [T]he recognition of investment income on attributed assets is relevant only for the attribution of profits to the PE under Article 7 and does not carry wider implications as regards, for example, withholding taxes.... **35**

> [T]he recognition of the notional royalty is relevant only to the attribution of profits to the PE under Article 7 and should not be understood to carry wider implications as regards withholding taxes.... **36**

Notably, this same treatment of interbranch transactions is applied by the global dealing Regulations under **Prop. Reg. 1.482-8** . A branch/QBU can be a participant in a global dealing "operation" under **Prop. Reg. 1.482-8** (branches are treated essentially as separate enterprises and interbranch trades referenced for the purpose of determining the proportionate amount of global dealing income to be allocated to the participating branches in the global dealing activity). **Prop. Reg. 1.863-3(h)(3)(iii)** says:

> Treatment of interbranch and interdesk amounts. *An agreement among QBUs of the same taxpayer to allocate income, gain or loss from transactions with third parties is not a transaction because a taxpayer cannot enter into a contract with itself.* For purposes of this paragraph (h)(3), however, such an agreement, including a risk transfer agreement...may be used to determine the source of global dealing income from transactions with third parties in the same manner and to the same extent that transactions between controlled taxpayers in a global dealing operation may be used to allocate income, gain or loss from the global dealing operation under the rules of [**Reg. 1.482-8** . (Emphasis added.)

Moreover, the Preamble to **Prop. Reg. 1.482-8** notes that the approach of the global dealing Regulations is consistent with applicable income tax treaties:

> Because the proposed regulations contained in this document allocate global trading income among permanent establishments under the arm's length principle of the Associated Enterprises article of U.S. income tax treaties, such rules are consistent with our obligations under the Business Profits article. Accordingly, a proposed rule under section 894 provides that, if a taxpayer is engaged in a global dealing operation through a U.S. permanent establishment, the proposed regulations will apply to determine the income attributable to that U.S. permanent establishment under the applicable U.S. income tax treaty.

Accordingly, as there is no authority to give effect to internal dealings for U.S. tax purposes, interbranch transactions should not be treated differently under the AOA than they are under the Code. Indeed, the guidance that has been issued in this area in regard to interest says (as under the Code) that the treaty does not prevent the BLIT from being imposed on excess interest attributed to interbranch funding (i.e., it does not suggest that interbranch amounts be treated as recognized transactions for purposes of applying **Section 1441** and **Section 1442** instead). **37**

Notice 89-80, 1989-2 CB 394 , says:

> [T]he permanent establishment nondiscrimination provision does not require structural or mechanical identity between the methods used to determine the United States tax liability of such foreign and domestic corporations, respectively, so long as the net result of such methods is approximately the same, i.e., the tax burden imposed on a foreign corporation in respect of its United States permanent establishment approximates the tax burden that is imposed on an enterprise of the United States engaged in the same activities.

> **Section 884(f)(1)(B)** treats the excess as if it were U.S.-source interest paid by the domestic subsidiary to the foreign parent corporation. This treatment recognizes that excess interest with respect to a branch is the functional equivalent of interest paid on parent debt funding with respect to a subsidiary.

Thus, there is no authority to provide that interbranch amounts be treated as recognized for BEAT or any purpose other than to serve as a reference for profits attribution under the AOA.

Authors' perspective. Internal dealings that are recognized for transfer pricing purposes under the AOA do not create transactions between separate entities or separate legal obligations but merely provide a benchmark for transfer pricing purposes. Accordingly, the treatment of the foreign bank as the taxpayer in whole is not changed by application of the AOA and internal dealings within the bank should not be BEAT transactions.

Q: *What is the broader impact of the AOA on BEAT?*

As noted, the AOA deals with the allocation of profits under Article 7 of an applicable income tax treaty. Branch taxes such as branch profits tax (BPT) and more particularly BLIT are related to Articles 10 (Dividends) and 11 (Interest). It is likely, therefore, that the related **Section 884(f)** analysis discussed above would apply similarly under the AOA as well.

Authors' perspective. An analysis similar to that of above should apply to a foreign bank under an AOA methodology.

1 See **Section 59A(f)** and (g).

2 The applicable tax rate is 10% (5% for tax years beginning in 2018), and 12.5% for tax years beginning after December 31, 2025 under **Sections 59A(b)(1)(A)** and (2). The tax rate is increased by 1% for certain (i.e., **Section 581**) banks and securities dealers under **Section 59A(b)(3)** .

3 See **Reg. 1.882-5** .

4 That is, interest paid on "U.S. book liabilities", as discussed in the text below.

4.1 Guidance may be issued in this area providing that a portion of the excess be treated as BEAT. The authors believe that it is critical to the inbound banking industry that such guidance, if issued, provide exemptions for the issues discussed below regarding the treatment of a portion of the excess interest as BEAT.

5 See **Reg. 1.882-5(a)(1)** .

6 Generally, its assets effectively connected with its U.S. trade or business under **Reg. 1.884-1(d)** .

7 Reg. 1.882-5(c) .

8 Regs. 1.882-5(d) and (e).

9 Reg. 1.882-5(d)(2) .

10 This is usually because U.S. assets are being funded with interbranch liabilities.

11 Reg. 1.882-5(d)(5) .

12 Reg. 1.882-5(d)(4) .

13 See Leeds, "Revisiting U.S. Taxation of Global Banking: NatWest II and Its Implications for Foreign Bank Branches," 5 Derivatives: Financial Products Report 1 (January 2004).

14 Section 884(f) (Treatment of interest allocable to effectively connected income) says:(1) In general. In the case of a foreign corporation engaged in a trade or business in the United States (or having gross income treated as effectively connected with the conduct of a trade or business in the United States), for purposes of this subtitle-(A) any interest paid by such trade or business in the United States shall be treated as if it were paid by a domestic corporation, and(B) to the extent that the allocable interest exceeds the interest described in subparagraph (A), such foreign corporation shall be liable for tax under section 881(a) in the same manner as if such excess were interest paid to such foreign corporation by a wholly owned domestic corporation on the last day of such foreign corporation's taxable year. To the extent provided in regulations, subparagraph (A) shall not apply to interest in excess of the amounts reasonably expected to be allocable interest.(2) Allocable interest. For purposes of this subsection, the term "allocable interest" means any interest which is allocable to income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

15 Section 884(f)(1)(A) .

16 Section 884(f)(1)(B) .

17 Reg. 1.884-4(a)(2) .

18 These Regulations have remained in proposed form since their issuance.

19 RRA '89, P.L. 101-239, December 19, 1989.

20 *Swallows Holding, Ltd.*, **126 TC 96** , 129 (2006); 515 F.3d 162 (CA-3, 2008).

21 See *Gottesman & Co., Inc.*, **77 TC 1149** (1981). See also *Ivan Allen Co.*, 422 U.S. 617 , 627 (1975), holding that an ambiguity that was of the Commissioner's making must be held against him.

22 See Section 59(A)(b)(2).

23 However, given Treasury's authority to write interpretative Regulations and knowing that the treatment of the **Reg. 1.882-5** deduction will probably soon be under consideration by Treasury, a bank may want to weigh the impact of an alternative scenario where a portion of the excess interest such as this may be treated as BEAT.

24 (i) General rule. If the amount of branch interest that is both paid and accrued by a foreign corporation during the taxable year (including interest that the foreign corporation elects under paragraph (c)(1) of this section to treat as paid during the taxable year) exceeds the amount of interest allocated or apportioned to ECI of a foreign corporation under Section 1.882-5 for the taxable year, then the amount of the foreign corporation's branch interest shall be reduced by the amount of such excess as provided in paragraphs (b)(6)(ii) and (iii) of this section, as applicable. The rules of paragraphs (b)(6)(ii) and (iii) of this section shall also apply where the amount of branch interest with respect to liabilities identified under paragraph (b)(1)(ii) of this section exceeds the maximum amount that may be treated as branch interest under that paragraph....(iii) Election to specify liabilities that do not give rise to branch interest. For purposes of reducing the amount of branch interest under paragraph (b)(6)(i) of this section, a foreign corporation may, instead of using the method described in paragraph (b)(6)(ii) of this section, elect for any taxable year to specify which liabilities will not be treated as giving rise to branch interest or will be treated as giving rise only in part to branch interest. Branch interest paid during the taxable year with respect to a liability specified under this paragraph (b)(6)(iii) must be reduced to zero before a reduction is made with respect to branch interest

attributable to the next-specified liability.... A foreign corporation that elects to have this paragraph (b)(6)(iii) apply shall note on its books and records maintained in the United States that the liability is not to be treated as giving rise to branch interest, or is to be treated as giving rise to branch interest only in part. Such notation must be made after the close of the taxable year in which the foreign corporation pays the interest and prior to the due date (with extensions) of the foreign corporation's income tax return for the taxable year. However, if the excess interest in paragraph (b)(6)(i) of this section occurs as a result of adjustments made during the examination of the foreign corporation's income tax return, the election and notation may be made at the time of examination. The amount of interest that is not treated as branch interest by reason of this paragraph (b)(6)(iii) shall not be treated as paid by a domestic corporation and thus shall not be subject to tax under section 871(a) or 881(a).

25 That is, a methodology that is alternative to the "all or nothing approach" under the Code and Regulations, which applies to determine income that is effectively connected with a foreign bank's U.S. trade or business. See **Section 864(c)** and **Reg. 1.864-4(c)(5)** . See also Villano, Naughton, and Mudd, "Can Treaties Bring Peace to the IRS and Foreign Banks?" (Part 1), **25 JOIT 23 (August 2014)** .

26 For these purposes a U.S. branch should generally qualify as a PE.

27 See U.S. Treasury Technical Explanation to the 2006 U.S. Model (Article 7(2)) (emphasis added).

28 Prop. Reg. 1.863-3(h)(3)(iii) .

29 U.S. Model Tax Convention (2016). The 2006 U.S. Model (Article 7(2)) used slightly different language: "[W]here an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits that it might be expected to make if it were a *distinct and independent* enterprise engaged in the same or similar activities under the same or similar conditions. For this purpose, the profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment." (Emphasis added.) All U.S.-EU treaties that allow for an AOA approach, e.g., Belgium, Canada, Germany, Japan, U.K., use "distinct and independent" or "distinct and separate" based on the older Model.

30 See OECD 2010 Report on the Attribution of Profits to Permanent Establishments, July 22, 2010, Part I, para. B-1, *et seq.* See also *Nat'l Westminster Bank, PLC*, 512 F. 3d 1347 (CA-FC, 2008) ("NatWest IV") and Villano, Naughton, and Mudd, *supra* note 25.

31 This is consistent with the congressional view that a treaty does not require a PE to be treated as if

it were a separate entity for all purposes and that "different but comparable tax treatment that reflects the different circumstances of foreign-owned and domestic owned businesses" is not inconsistent with the treaty." U.S. Congress, House of Representatives, Committee on the Budget, 1989, *Omnibus Budget Reconciliation Act*, 101st Cong., 1st Sess., H.R. 101-247.

32 OECD 2010 Report on the Attribution of Profits to Permanent Establishments, July 22, 2010, Part 1, B-2, section 11, www.oecd.org/ctp/transfer-pricing/45689524.pdf.

33 *Id.* Part I, A, section 3.

34 Note 27, *supra*.

35 OECD Report, *supra* note 32, Part IV, C-1(iii)(f), section 166.

36 *Id.* Part I, D-3(b)(1), section 203.

37 In this regard, **Reg. 1.882-5(c)(2)(viii)** (Interbranch transactions) says: "A transaction of any type between separate offices or branches of the same taxpayer does not create an asset or a liability."

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