NEWS ANALYSIS

BEAT and Banks, Part 2

by Lee A. Sheppard

Deutsche Bank AG, the world's most dangerous bank, is looking for some dumb money. Make that dumber dumb money.

Chinese conglomerate HNA is selling its 3 percent Deutsche equity investment. So now Deutsche is looking to the Qatari investment funds for an increase in their nearly 10 percent equity investment. BlackRock owns 6 percent of the bank. Large shareholders have rights to acquire more shares if they're silly enough to throw good money after bad.

Analysts have long believed that Deutsche is insolvent, and its shares sell at less than €7 — a quarter of book value — having fallen by more than 50 percent in 2018. You read that right: Europe's largest bank is a pfennig stock. Its bail-in contingent convertible bonds are trading at 84 centimes on the euro. Christopher Whalen of Whalen Global Advisors believes that the bank could fail in 2019. The proposed merger with fellow German giant Commerzbank is not a good sign. Commentator Wolf Richter believes Deutsche has been in a death spiral since 2007.

To add to the bank's troubles, Deutsche has paid $18 billion in fines over the last decade for rigging markets and other misdeeds — an amount nearly equal to its market capitalization. Recently the European Commission accused it of colluding to rig dollar-denominated sovereign bond markets. Deutsche settled LIBOR rigging allegations, while two of its traders were found guilty. The bank departed the commodities market after being investigated for rigging gold and precious metals markets. In November, Deutsche's Frankfurt offices were raided by German police following up on the Panama Papers. The New York State Department of Financial Services fined it for operating a giant Russian money laundry. The U.S. Justice Department fined it $7 billion for mortgage-backed securities fraud. The fine for bond market rigging could be as much as 10 percent of annual worldwide revenue (*The Wall Street Journal*, Dec. 20, 2018).

Deutsche is the world's largest global systemically important bank (GSIB). Its $2 trillion total assets equal nearly half of German GDP. Its €49 trillion notional derivatives exposure is larger than that of similarly sized JPMorgan — a derivatives dealer with a bank attached. But it is well capitalized by current standards. Its Tier 1 capital is €48 billion, and its Tier 1 capital ratio is 14 percent. It has a leverage ratio of 4 percent; recall that this Basel III requirement really threw undercapitalized European banks for a loop. Deutsche's loss absorption capacity is €118 billion — more than current estimates of the total bad loans on the books of German banks. Its loan-to-deposit ratio of 0.77 is on par with its U.S. counterparts. Why are its shares in the doghouse? Because it isn't profitable.

The German government, which is believed to have contingency plans, won't let Deutsche fail, but saving it would require money creation, which is anathema to the government and the European Central Bank. Meanwhile, its U.S. affiliate, Deutsche Bank Trust Company Americas, went on the FDIC's secret problem banks list, a year after the Fed designated it a troubled institution, citing problems with systems and controls. It has twice failed Fed stress tests (*Financial Times*, May 31, 2018; *The Wall Street Journal*, June 1, 2018).

And in nonfinancial news, Louise Linton, the self-sabotaging wife of Treasury Secretary Steven Mnuchin, is back on Instagram! She's doing charitable work and using Instagram to publicize it — meaning that she has been assigned a babysitter and is in control of neither her account nor her daily schedule. In other words, she's finally doing the job that official escorts are supposed to do. She may find herself laying a wreath for Deutsche Bank after it fails.

Lady Louise gets a job. (Debbie Hill/UPI/Newscom)

Deutsche may have to use its precious borrowed dollars to pay income taxes to the United States — derivatives dealing being its only profitable business. The new Tax Cuts and Jobs Act base erosion and antiabuse tax will hit foreign-parented banks hard. BEAT operates like a minimum tax — the taxpayer's regular tax with credits is compared with BEAT liability without credits other than the research credit (section 59A). Proposed regulations interpreting this new law were issued on December 13 (REG-104259-18).

The proposed BEAT regulations were discussed by a panel at the December 19 meeting of the fall conference of the International Fiscal Association USA branch, New York region. The emphasis was on the effect on banks. Panelists included Mark Leeds of Mayer Brown, Clarissa Potter of KPMG, and Howard Sacarob of Royal Bank of Canada.

Background

BEAT is effectively a 5 percent add-on minimum tax on base erosion payments, when those payments comprise 3 percent of the group's deductions (with exclusions like net operating losses) ("base erosion percentage") (section 59A(c)(4)). BEAT partially disallows deductions for interest, royalties, and other deductible payments ("base erosion payments") to related foreign persons (section 59A(d)). Base erosion payments are reportable (section 6038(b)(2); prop. reg. section 1.6038A-2).

The BEAT threshold for related status is a low 25 percent of voting power or value (section 59A(d)(1); prop. reg. section 1.59A-1(b)(17)). The BEAT aggregation rule aggregates all entities considered a single employer, using a 50 percent threshold, for purposes of the base erosion percentage (sections 52(a), 59A(e)(3)). All members of an affiliated group are treated as a single BEAT taxpayer, so payments within that group are ignored (prop. reg. sections 1.1502-2(a)(9), 1.1502-59A). Otherwise, members of the aggregated group determine and pay BEAT individually.

The statute has a $500 million aggregated group annual gross receipts threshold, which this article assumes is met by financial groups (section 59A(e)). Gross receipts and base erosion percentage are the points to entry to BEAT.

So the relevant group is the aggregated group for purposes of the thresholds, but then the foreign members have to be peeled off to create base erosion payments.

> ***If all payments between members of the aggregated group were not base erosion payments, there would be no BEAT. So the rule ignoring only ECI payments to foreign affiliates had to be made.***

"Foreign person" is defined as any person not a U.S. person (sections 59A(f), 6038A(c)(3)). "Related party" also requires a person (section 59A(g)). A foreign corporation is not considered part of the aggregated group, except to the extent that it produces effectively connected income (prop. reg. section 1.59A-1(b)(1)(ii)). So for purposes of gross receipts and the base erosion percentage, the aggregated group consists of 50-percent-owned domestic corporations and foreign corporations to the extent of ECI.

Foreign corporations are included in the aggregated group to the extent of the receipt of ECI payments, and then payments among aggregated group members are ignored. A non-ECI payment to the same related foreign corporation is a base erosion payment.

The same foreign member will be a member of the aggregated group for some purposes and not others. It is a member of the aggregated group for transactions that produce ECI. It is not a member for transactions that don't produce ECI or that do produce subpart F income. If the foreign member was in a treaty country, the ECI question would be whether the transaction produced income attributable to a permanent establishment. This administrative regime is good news for foreign bank groups with U.S. branches that are making and receiving payments to and from the group's U.S. subsidiaries.

If all payments between members of the aggregated group were not base erosion payments, there would be no BEAT. So the rule ignoring only ECI payments to foreign affiliates had to be made. "The statute only makes sense with this change," said Leeds. "They're effectively redrafting the statute to bring in the revenue it's supposed to bring in."

Deductible payments between members of the aggregated group will not enter into the base erosion percentage, either in the numerator (base erosion deductions) or the denominator (aggregated deductions plus base erosion deductions minus base erosion exclusions). In the denominator are current net operating losses, BEAT exclusions, and special deductions for global intangible low-taxed income and repatriations (prop. reg. section 1.59A-3).

There is a problem when group members have different tax years, Potter and Sacarob pointed out. The proposed rules require each aggregated group member to conform aggregated group data to its particular tax year and those members that are members of the aggregated group at the end of that year for purposes of determining gross receipts and base erosion percentage (reg. section 1.59A-2(d), -2(e)(3)(vii)). The preamble admits that members may have different gross receipts and base erosion percentages. This rule would create data collection problems, but the drafters rejected the idea of assigning one tax year to the aggregated group.

BEAT doesn't apply to partnerships. The proposed regulations look through partnerships to apply the base erosion percentage and gross receipts tests to U.S. and foreign partners as payers and payees, according to how those receipts and disbursements are allocated to them. The proposed rules will look through tiers of partnerships to attribute payments to partners. If a partner's partnership interest is worth less than $25 million and the partner owns less than 10 percent of partnership equity and income, the proposed rules will not look through the partnership for the base erosion percentage test (prop. reg. section 1.59A-7).

The statute grants Treasury wide antiabuse rule authority (section 59A(9)(i)). The proposed antiabuse rule would reach transactions designed to avoid BEAT through the use of intermediaries when there is a principal purpose to avoid BEAT (prop. reg. section 1.59A-9(b)(1)). The rule also reaches attempted increases in the denominator of the base erosion percentage (prop. reg. section 1.59A-9(b)(2)). Offsetting long and short positions would be an example of this abuse (prop. reg. section 1.59A-9(c)(5), Example 5). The rule reaches attempts to keep U.S. banks and securities dealers outside the group (prop. reg. section 1.59A-9(b)(3)).

Financial Groups

The base erosion percentage threshold is 2 percent if the aggregated group includes an affiliated group with a member that is a bank or a registered securities dealer under the Securities Exchange Act of 1934. As a single taxpayer, the affiliated group would pay the higher BEAT rate for financial groups (section 59A(b)(3)). There is a de minimis rule for nonfinancial groups, like retailers or insurance groups, with little lending or dealer operations accounting for less than 2 percent of their gross receipts (reg. section 1.59A-1(e)(2)(ii)).

Bank is defined under section 581 as a U.S. incorporated bank doing business in the United States (section 59A(b)(3)(B)). Foreign bank is not listed (section 585(a)(2)). A foreign bank is technically not a bank because it is not organized in or licensed by the United States (section 582). The preamble confirms this reading. If a foreign bank only does business in the United States through a U.S. branch, and owns no U.S. banks or securities dealers, it will be subject to the 3 percent threshold. But a foreign bank group would be subject to the 2 percent threshold if any member of its aggregated group is a U.S. bank or regulated securities dealer. According to the preamble, this is the case even when that U.S. bank or dealer is making a payment to a foreign corporation, which cannot be a member of its own affiliated group.

Payments that create ECI will not be base erosion payments under the proposed rules (prop. reg. section 1.59A-3(b)(3)(iii)(A)). The payee must receive a Form W-8ECI withholding certificate for the exclusion to be available. The Institute of International Bankers (IIB) had asked for an administrative exclusion for deductible payments that create ECI, arguing that there is no earnings-stripping concern.

ECI is included in the denominator of the base erosion percentage fraction. Leeds pointed out that some types of payments are excluded from both the numerator and the denominator of the base erosion percentage fraction. Despite the obvious benefit of exclusion, the removal of section 988 items, qualified derivative payments, or total loss absorption capacity (TLAC) interest from the denominator means that financial groups are still likely to fall into BEAT because of all their other deductible related-party payments going into the numerator.

Leeds argued that the denominator was being unfairly shrunk by the exclusion of these payments, to the detriment of financial groups. "It honestly seems like this is a bank tax," said Leeds. Potter mused that the drafters could have fixed the denominator problem. The preamble explains that, as with ECI payments, inclusion in the denominator is confined to payments included in the U.S. tax base. So if a qualified derivative payment to a foreign related counterparty were taxable as ECI, it would be included in the denominator.

Interest Payments

BEAT picks up where the interest barrier rules leave off, so it applies to the remainder of the taxpayer's interest expense. So BEAT reaches interest expense allowed under section 163(j). Current interest expense is allocated first to unrelated-party payees and then to related payees, maximizing the amount subject to BEAT, because disallowed interest goes first to unrelated (section 59A(c)(3)). The proposed rules treat related-party interest expense as proportionally allocable between domestic and foreign related payees (prop. reg. section 1.59A-3(c)(4)). The proposed rules exclude pre-TCJA interest carryforwards from base erosion payments, reversing the previous notice (prop. reg. section 159A-3(b)(4)(vi)). (See Notice 2018-28, 2018-16 IRB 492.)

How a foreign bank allocates interest expense to its U.S. branch can make a big difference to its BEAT liability (reg. section 1.59A-3(b)(4)). The method of figuring out what interest expense properly belongs to the branch shouldn't matter, but it does. Even if a foreign group ultimately does all its borrowing from third parties, the proposed regs only partially look through intragroup borrowing when the U.S. branch borrows from an affiliate that borrows from third parties. Moreover, when the group borrows, some interest expense is properly allocable to the U.S. branch, perhaps more than what was booked to the branch.

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Foreign banks choose between formulary methods and treaty-based allocation of expenses to a U.S. branch. Most foreign banks with U.S. branches use the formulaic methods of allocation of interest expense to U.S. branches (reg. section 1.882-5(b)-(d)). A choice of formulary method is binding for five years, making BEAT-inspired switches impossible (reg. section 1.882-5(a)(7)). Interest expense booked to the U.S. branch or directly allocated to ECI plus a portion of excess interest constitute base erosion payments.

Many foreign banks use the method that multiplies the taxpayer's average U.S. assets by its worldwide leverage ratio (reg. section 1.882-5(c)). Indeed, foreign banks enjoyed using these allocation methods in combination with hybrid entities to allocate all of their U.S. interest expense against ECI. Sometimes arbitrage of U.S. allocations and foreign rules for deductions by corporate entities could produce a double-dip interest deduction.

Essentially, the proposed BEAT regulations say that a section 882 allocation is a fungible allocation from a pool of interest expense. So the proposed rules look through all non-U.S. booked liabilities to arrive at a scaling ratio that is a percentage of related-party interest expense. That percentage is a base erosion payment. The drafters didn't have to do it that way. The applicable statutes justify a position that all allocated interest expense is base erosion payments.

If the U.S. booked liabilities exceed the U.S. allocated liabilities, the above rule for related-party interest applies to determine which booked interest is a base erosion payment. If there is excess interest expense because U.S. connected liabilities exceed U.S. booked liabilities, the proposed rules treat part of it as a base erosion payment, using a scaling ratio. The proposed rules limit the base erosion payment for excess interest to the proportion of the foreign bank's worldwide liabilities held by foreign related parties (reg. section 1.59A-3(b)(4)(A)(i)(2)). If the foreign related payee has to treat the allocated interest as ECI or U.S. taxable income, it is not a base erosion payment (prop. reg. section 1.59A-3(b)(4)(iv)).

Leeds and lawyers from Debevoise & Plimpton LLP question the authority for the inclusion of any excess interest, because as a notional deduction, it's not a payment, so they argue it should not be a base erosion payment. But what they're complaining about was actually a concession.

Technically, the notional interest deduction represented by excess interest is a payment deemed paid by a domestic corporation to a foreign related party for all purposes of the code, not merely withholding tax purposes (section 884(f)). If the regulation drafters had literally applied this code section, which was untouched by the TCJA, every dollar of excess interest would be a base erosion payment. But they did not do that. They permitted some look-through to the related-party liabilities to remove some excess interest from base erosion payments.

There is a different limit if the foreign bank uses the currency pools method (reg. sections 1.59A-3(b)(4)(B), 1.882-5(e)). Base erosion payments include all interest paid or accrued to foreign related parties and interest expense attributable to each currency pool as a proportion of the foreign bank's worldwide liabilities in that currency held by foreign related parties. So all interest expense is potentially a base erosion payment, depending on the extent to which the foreign parent has borrowed from related parties.

> ***Foreign banks argued that when the ultimate question is allocation of unrelated interest expense incurred by the whole foreign bank group, associated intra-branch payments should be excluded from base erosion payments.***

A foreign bank with parent-level borrowing only in foreign currencies can't just bounce into the currency pool method because of the five-year rule. If it uses the adjusted U.S. booked liabilities method, and all U.S. dollar borrowing is already booked to the U.S. branch, theoretically there could be no base erosion payments (reg. section 1.882-5(d)). That is, there is no good way to apply the BEAT rule to excess interest denominated in foreign currencies on foreign currency borrowing. The regulation drafters might want to make an ordering rule.

Some foreign bank representatives argued that when the ultimate question is allocation of unrelated interest expense incurred by the whole foreign bank group, associated intra-branch payments should be excluded from base erosion payments. That is, there should be a full look-through to the third-party borrowing. Treasury didn't buy that argument, but is looking for simplifying elections like those provided by the section 882 regulations. Foreign banks have a lot of excess interest. Other deductions also have to be allocated to the branch, making them base erosion payments (reg. section 1.882-4(a)(1)).

The creation of a notional interest deduction for excess interest encourages the use of the formulaic methods, but the idea that such a deduction would become a base erosion payment may discourage it. Foreign banks may not like the result of increased base erosion payments, Leeds suggested, even though nothing in the proposed rules changes the amount of interest allocable to a U.S. branch. Charles Cope, a sole practitioner, wondered whether a taxpayer might not want to use a treaty-based method instead to assert more control over its level of base erosion deductions.

If the group uses a treaty-based method based on hypothetical internal dealings to allocate interest expense to a permanent establishment, all interest expense (other than direct allocations to ECI) is treated as a base erosion payment (reg. section 1.59A-3(b)(4)(v)(A)). Direct allocations to ECI are reductions in gross income treated separately from formulary interest allocations (reg. section 1.882-5(a)(1)(ii)(A) or (B)). A base erosion payment would be created for any treaty interest allocable to a U.S. branch, even though it is not recognized for any other tax purpose (prop. reg. section 159A-3(b)(4)(v)(B)). Thus, actual branch payments and hypothetical internal dealings are treated alike.

But an interest payment would not be a base erosion payment if it creates ECI (prop. reg. section 1.59A-3(b)(4)(iv)). So payments of interest to a U.S. branch of a foreign parent will not be base erosion payments for purposes of the base erosion percentage. Some foreign bank groups borrow from their U.S. branches to finance their U.S. groups, Leeds pointed out. Technically, when a U.S. group member, such as a dealer, makes an interest payment to a U.S. branch of the foreign bank, it has made a deductible payment to the foreign bank, because the branch is not regarded by the U.S. system.

The proposed rules made an exception for payments on TLAC securities required by the Fed for foreign-parented GSIBs operating in the United States, like Deutsche (prop. reg. section 1.59A-1(b)(18), (20)). The Fed's TLAC rules require foreign banks to set up an intermediate holding company to hold U.S. affiliates, including those with securities dealer licenses. That holding company must issue unsecured, subordinated TLAC hybrid debt to its foreign parent bank holding company. The proposed rules would limit TLAC deductions to interest on the amount of TLAC securities required by the Fed, based on adjusted issue price (prop. reg. section 1.59A-3(b)(3)(v), 12 C.F.R. section 252).

Leeds griped that many foreign banks that are not GSIBs nonetheless adopted TLAC-like structures for prudence in their capitalization or to comply with home-country laws. These groups would not be permitted to exclude hybrid interest payments from base erosion payments. As the IIB argued, he maintained that the TLAC exception should look through to the mirror obligation between the foreign parent and the public that is usually in place. Treasury did not take this approach, but asked for comments on leveling the playing field among banks.

Securities Dealers

Base erosion payments do not include dealer payments on derivatives (section 59A(h)(4)). That means dealer payments on derivatives are excluded from both the numerator and the denominator of the base erosion percentage fraction (prop. reg. section 1.59A-3(b)(3)(ii)). Qualified derivative payments must be reported as a condition of being excluded (section 6038A(b)(2)). The taxpayer must be a mark-to-market taxpayer that treats the marks as ordinary, and treats gain or loss on the contract as ordinary — effectively a dealer (section 475).

But the statute doesn't say whether a mark should be treated as a payment for BEAT purposes. Under the proposed regulations, a mark is a payment (prop. reg. section 1.59A-3(b)(2)(iii)). A section 475 taxpayer will use a single net deduction number for the annual base erosion percentage fraction (prop. reg. section 1.59A-2(e)(3)(vi)). There is a prospective reporting requirement (prop. reg. section 1.6038A-2(b)(7)(ix), -2(g)). KPMG practitioners pointed out that the proposed regulations do not delimit the transaction or position, which is necessary to determine what is a payment. Moreover, the rule contemplates annual marks, and some taxpayers mark more frequently.

The proposed rules would permit less netting than some financial groups might want. There is no general netting of base erosion payments (prop. reg. section 1.59A-3(b)(2)(ii)). If the underlying law permits netting to produce the deductible amount, the BEAT does not change that. Otherwise, the BEAT works on gross deductions. Interest payments flying back and forth between group members are not netted for BEAT. Reinsurance premiums are not netted against claims payments for BEAT. Taxpayers' systems generally net these payments, and it may be hard to dig out gross payments, even when there is a tax benefit for doing so.

Under the proposed regulations, swaps books can be grossed up in determining the denominator of the base erosion percentage, according to Leeds. But getting to a gross number is not as easy as it looks. Swaps books tend to be netted all the way through. So data mining might be required to get to gross numbers, Sacarob commented, which might turn out to be impossible.

The statute does not define derivative, except to say what is excluded. American depositary receipts and insurance contracts are not derivatives. The proposed rules interpret the term narrowly, excluding loanlike instruments with reference assets or collateral (section 59A(h)(4)). Repos and securities loans are not covered by the derivatives exception (prop. reg. section 1.59A-(d)(2)(iii)). Some lawyers worry that this means that substitute payments, fees, and marked losses on securities loans would be base erosion payments.

> ***There is no general netting of base erosion payments. If the underlying law permits netting to produce the deductible amount, the BEAT does not change that. Otherwise, the BEAT works on gross deductions.***

If the derivative is a mixed contract, payments on the non-derivative part are base erosion payments, but the proposed rule does not say how to segregate the non-derivative component (section 59A(h)(3)). The preamble states that Treasury views this rule as self-executing, and asks for comment on whether rules are needed.

Global Dealing

What happens if the group has a global dealer book and formulary allocation of items to participants? Are reductions in gross income treated as deductions for BEAT purposes? Reinsurance premiums are statutorily treated as base erosion payments, even though they are technically reductions in gross income (section 59A(d)(3)). There is no similar statutory treatment for global dealing allocations.

The proposed BEAT regulation is not a transfer pricing regulation. Derivatives dealers are permitted to rely on the 20-year-old proposed global dealing regulations, which prescribe various transactional and profit-split methods based on market benchmarks (prop. reg. section 1.482-8(b) through (f); and reg. section 1.482-9(m)(6)). These rules prescribe two profit-split methods (prop. reg. section 1.482-8(e)). (Prior analysis: *Tax Notes Int'l*, Aug. 13, 2018, p. 665.)

The profit-split methods do not change the underlying contracts or the character of payments that were actually made. Tax ownership doesn't cross entity lines. Certain member entities legally own certain assets, even if other member entities sell those same assets to customers. Those customer-facing affiliates earn service fee income. They don't get a pro rata amount of each item earned by the capital provider, which retains risk.

When global dealing allocations are made across separate legal entities, the income being allocated retains its character within the entity that has tax ownership and bears the risk of loss. There has been no shift of ownership of the underlying income and gains.

So when a related party performs what transfer pricing calls participant functions, those functions are services. The global dealing regulations do not change the character of the services function, but merely use different comparability factors more appropriate to a financial dealer business. Under section 59A and the new proposed BEAT regulations, that service fee may be a base erosion payment.

When, however, global dealing allocations are between branches of the same entity for U.S. tax purposes (including between a parent entity and a disregarded entity), global dealing income earned within the same entity is merely allocated under separate source and ECI rules (prop. reg. section 1.863-3(h)(3)). No new income is created by the global dealing allocation. The regulations state that "in applying the principles of section 1.482-8, the taxpayer shall take into account the economic effects of conducting a global dealing operation through a single entity instead of multiple legal entities" (prop. reg. section 1.863-3(h)(3)(ii)). The allocated amounts are expressly provided "disregarded transaction" treatment (prop. reg. section 1.863-3(h)(3)(iii)).

That is, whether a global dealer has a BEAT liability may depend on how its operations are organized. Branches produce better BEAT results than separate legal entities.

BEAT liability does not depend on the source of the payment. BEAT treats fees for services performed abroad as base-eroding payments when a U.S. taxpayer pays service fees to a foreign related party. BEAT merely asks whether the U.S. side made or is deemed to have made a deductible payment to a foreign related party.

For a global derivatives book, typically one member entity is the owner of the derivative income. The global dealing regulations contemplate only one capital risk-taking provider in a global dealing operation. The bilateral transactions between the affiliates and perhaps a customer-facing capital provider must be adjusted to explain the profit-split result, while character of income is retained (prop. reg. section 1.482-8(e)(2)).

> ***Whether a global dealer has a BEAT liability may depend on how its operations are organized. Branches produce better BEAT results than separate legal entities.***

The customer-facing affiliates may make qualified derivative payments to related parties. Those contractual payments clearly would not be base erosion payments when made between separate legal entities, even though a transfer pricing analysis may approximate a service-based profit-split allocation for services performed as a transacting agent for the client-facing capital provider.

Some banks run their fixed income derivatives books through branches. Customers are often required to face the parent or the best-capitalized entity in the dealer group. Regulatory capital costs may dictate recording certain customer-facing transactions in particular entities. In transfer pricing lingo, the customer-facing branch would be performing a participant function that has to be compensated by an allocation of income.

An interbranch allocation of the qualified derivative income is an allocation within the same legal entity. No service fee would be created, even though the customer-facing branch could be said to have provided a service to the capital provider. Therefore, no base erosion payment would be created.

But when the customer-facing service provider is a separate legal entity for tax purposes, service fee status attaches to a profit allocation of qualified derivative income. Remember, transfer pricing is highly respectful of separate legal entities and demands an explanation for each profit allocation between entities. The regulations drafters didn't bother to say that this service payment between separate legal entities should be treated as derived from underlying qualified derivative income.

The proposed regulations provide a limited look-through for allocated interest expense, but do not do the same for qualified derivative payments. Still, the preamble teases about this possibility.

The preamble states that the exclusion is available for "*any payment* made by a taxpayer to a foreign related party pursuant to a derivative for which the taxpayer recognizes gain or loss on the derivative on a mark-to-market basis, the gain or loss is ordinary, and any gain, loss, income or deduction on a payment made *pursuant to the derivative* is also treated as ordinary" (emphasis added). The regulation repeats this wording (prop. reg. section 1.59A-6(b)).

A payment for services determined by the global dealing rules may be "pursuant to" a qualified derivative payment because the payment is determined by reference to the results of the derivative transactions. That is, the phrase "pursuant to" could encompass payments beyond counterparty payments due on the derivatives contract. The reference to "any" payment arguably contemplates that a profit-split allocation for related party services may be deemed to be "pursuant to" a qualified derivative. However, the regulations do not have an example illustrating the treatment of a profit-split payment to a global dealing foreign related party participant.

Global dealers organized as separate legal entities could get around the BEAT problem by setting up back-to-back derivatives between capital providers and customer-facing affiliates, mirroring the derivatives sold to customers, so that there would be no service fees, only qualified derivative payments. That might require adjustments to the business model and increases in capital, which are unattractive to bankers (the joy of being an equity owner of a financial intermediary is leverage).

Practitioners argue that transfer pricing adjustments related to intragroup derivatives entered to back up customer-facing derivatives should also be eligible for the exclusion. The economic structure and result are the same regardless of whether the global dealer uses separate legal entities or branches. The regulations drafters might want to look through intragroup service fees to the underlying qualified derivative payments, at least when payments compensate services performed in connection with a global dealing operation. ■