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Mr. Douglas Poms
Deputy International Tax Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue Northwest
Washington, D.C. 20220

Dear Mr. Poms:

On behalf of the over 600 oil and natural gas companies the American Petroleum Institute represents, I want to thank you and your staff for your work on H.R. 1, *the Tax Cuts and Jobs Act of 2017*. As the Treasury Department continues its efforts to implement and clarify various aspects of the legislation through guidance, I want to raise an issue regarding the Base Erosion Adjustment Tax (BEAT) and net operating loss (NOL) pre-2018 carryovers.

The industry strongly believes that Treasury regulations for the BEAT should be written to ensure:

1. The net operating loss add back required under the BEAT is determined based on the base erosion percentage in the year the NOL arose, and

2. The BEAT add back for pre-TJCA losses carried into a post-TCJA year should be zero.

3. The use of a pre-2018 NOLs going forward should not be treated as a BEAT payment and are distinguishable from pre-2018 interest deductions deferred under section 163(j).

The attached document further details this request and speaks to specifics, provides background, and outlines several model calculations. Because the BEAT is an entirely new tax, API has developed these recommendations considering the need to minimize administrative burden, complexity, and minimize taxpayer inequity.

We welcome your consideration of this issue and stand ready to answer any questions you may have. We will be reaching out to you shortly to try an arrange a meeting to discuss this issue as well as treatment of FTC carryforwards and business income for the new branch basket. In the interim, please do not hesitate to contact our Director of Federal Relations for Tax Policy, Brian Johnson, at johnsonb@api.org.

Sincerely,

Stephen Comstock
Director – Tax & Accounting Policy
American Petroleum Institute

cc: U.S. House of Representatives Committee on Ways and Means & U.S. Senate Committee on Finance Members and staffs

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BEAT Regulatory Clarifications (Base Erosion Percentage and Pre-TCJA NOL)

QUESTIONS PRESENTED:

(1) Whether the net operating loss (“NOL”) add back required under the base erosion anti-abuse tax (“BEAT) (section 59A) is determined based on the base erosion percentage (“BE%”) in the year the NOL arose or in the year the NOL deduction is taken.

(2) How the BEAT NOL add back is applied to losses generated in years before the enactment of the Tax Cuts and Jobs Act (“TCJA”) and thus the BEAT (section 59A).

(3) Whether the proposed treatment of pre-2018 interest deductions per Notice 2018-28 should be controlling on the rules applicable to NOLs.

SHORT ANSWERS:

(1) The NOL add back should be based on the BE% in the year the NOL arose. Although not explained in the legislative history to BEAT, the only way to effect the apparent purpose of the rule is to apply the BE% for the year the NOL was created, rather than the BE% for the year to which the NOL is carried.

As illustrated in the examples below, adding back the BE% amount in the year to which the NOL is carried does not produce a rational result as such BE% is not correlated to the base erosion payments that generated the NOL.

(2) The BEAT add back for pre-TJCA losses carried into a post-TCJA year should be zero. Because the BEAT applies only to “base erosion payments” that are “paid or accrued” in taxable years beginning after 2017, BEAT should not apply to base erosion payments that were paid or accrued in taxable years beginning prior to 2018. This conclusion is supported by both the statute and legislative record.

As discussed in the context of question (1), there are sound policy reasons to conclude the base erosion percentage should be based on the taxpayer’s deductions in the year the NOL was created. Notwithstanding, if a decision is taken otherwise, in no event should a pre-tax reform NOL be included as an add back because the section 59A effective date precludes application of the BEAT to payments prior to December 31, 2017. Furthermore, a pre-2018 NOL deduction itself is not a separate and distinct base erosion payment in the year it is utilized, but rather the reflection of costs paid and accrued in a pre-tax reform year.

(3) No. Notwithstanding arguments to exclude pre-2018 interest deductions deferred under section 163(j) from BEAT, the treatment of pre-2018 NOLs is distinguishable because of the specific statutory language under both old and new section 163(j), language which is absent from sections 59A and 172. IRC section 163(j) specifically treats deferred interest expense as “paid or accrued” in the year to which the deduction is carried. As such, the application of section 59A to such payment is statutorily different than considerations specific to an NOL. Conversely, an NOL carryover is not a deductible related party expense in the year the NOL is applied. Rather, the carryover of the pre-2018 NOL under section 172 simply creates a separate deduction equal to the amount of the carryover. If however, a decision is taken to exclude pre-2018 deferred interest deductions under section 163(j) from the BEAT, such a decision would further support the treatment of pre-2018 NOLs discussed above and below.

BACKGROUND:

The newly enacted base erosion anti-abuse tax ("BEAT") (section 59A), if it applies, imposes an additional tax equal to a U.S. corporation's base erosion minimum tax amount ("BEMTA"). BEAT generally applies to U.S. corporate groups with significant gross receipts (at least $500 million) that have made base erosion payments to foreign related parties that result in deductions or certain reductions in gross receipts equal to at least three percent of the sum of all their deductions and such reductions in gross receipts for the taxable year.

BEMTA is defined as the excess of 10 percent of modified taxable income ("MTI") (five percent in 2018) over a U.S. corporation's regular tax liability (generally 21 percent of taxable income reduced by most credits).

MTI is calculated by starting with taxable income and adding back:

(1) Base erosion tax benefits (generally base erosion payments or accruals ("payments") to foreign related persons, such as foreign related party payments or purchases of depreciable or amortizable property from foreign related parties, that give rise to a current deduction or reduction in gross receipts); and,
(2) The base erosion percentage ("BE%") of any net operating loss ("NOL") deduction for the taxable year.

BE% is determined, for any taxable year, by dividing base erosion tax benefits for the taxable year by all the payments that gave rise to a current deduction or to a current reduction in gross income included in base erosion tax benefits for the taxable year, other than deductions under sections 172, 245A, and 250 (and deductible amounts specifically excluded from base erosion payments). Section 59A does not specify whether the BE% of any NOL that is to be applied to the carryover is computed with reference to the year that the NOL arose or in the year the NOL deduction is taken. It refers only to the BE% for any NOL deduction, without specifying for which taxable year the BE% is to be determined.

Section 14401(e) of the Tax Cuts and Jobs Act (P.L. 115-97) provides that BEAT is effective for "***base erosion payments*** (as defined in section 59A(d)…) ***paid or accrued in taxable years beginning after December 31, 2017***" (emphasis added).

In Notice 2018-28, Treasury/IRS announced that they plan to issue regulations that would provide that pre-2018 payments or accruals of interest for which deductions were deferred under old section 163(j) would carry over and be treated as "paid or accrued" in post-2017 years and would thus be subject to both the newly amended section 163(j) and BEAT.

ANALYSIS/DISCUSSION:

A. Determining the BE% to apply; the year the loss was generated or the year it is applied/carried

Although not explained in the legislative history to BEAT, the add back in determining MTI of the BE% of any NOL deduction appears to be aimed at preventing prior year base erosion payments that did not offset gross income in the year of the NOL from offsetting gross income in the year(s) to which the NOL is carried without being subject to BEAT. The only way to effect the apparent purpose of the rule, however, is to apply the BE% for the year the NOL was created, rather than the BE% for the year to which the NOL is carried.

To illustrate, assume in 2018 a calendar year U.S. corporation, X, generates $600 million of gross income, makes deductible base erosion payments to foreign related parties (such as royalties and interest) of $550 million, and deductible non-related party payments of $100 million, thereby generating an NOL of $50 million and, based on 2018 deductions, a BE% of 85 percent. Further, assume that in 2019 the U.S. corporation generates $600 million of gross income, makes deductible non-related party payments of $500 million, and deductible base erosion payments of $50 million, thereby generating $50 million of taxable income and, based on 2019 deductions, a BE%

of 9 percent. X, therefore, carries forward $40 million of the 2018 NOL under the new law (80 percent of $50 million) to offset $40 million of its taxable income in 2019. If the BEAT NOL add-back is based on the BE% for the 2019 tax year, then X would be subject to BEAT of $3.6 million in 2019 as the result of the $40 million of base erosion payments made in 2018. However, if the BEAT NOL add-back is based on the BE% for the 2018 tax year, then X would be subject to $34 million of BEAT.

Example 1					
2018			**BE % (Current Year vs. Loss Year)**		
Gross Income	$ 600.00		If 2018, then BE % =	85%	(550/650)
Related Party Deductable Payments	$ (550.00)		If 2019, then BE % =	9%	(50/550)
Unrelated Party Deductible Costs	$ (100.00)				
Adjusted Taxable Income (Loss)	$ (50.00)		**BEAT effect of NOL add back**		
			If 2018 BE %, then	34	(40 x 85%)
			If 2019 BE%, then	3.6	(40 x 9%)
2019					
Gross Income	$ 600.00				
Related Party Deductible Payments	$ (50.00)				
Unrelated Party Deductible Costs	$ (500.00)				
Adjusted Taxable Income (Loss)	$ 50.00				
s172 NOL carryforward (80%)	$ (40.00)				

Alternatively, assume for tax year 2018 that taxpayer X generates $600 million of gross income, makes deductible makes deductible non-related party payments of $500 million, and deductible base erosion payments of $150 million, thereby generating an NOL of $50 million and, based on 2018 deductions, a BE% of 23%. Further, assume that in 2019 taxpayer X generates $600 million of gross income, makes deductible non-related party payments of $50 million, and deductible base erosion payments of $500 million, thereby generating $50 million of taxable income and, based on 2019 deductions, a BE% of 91% percent. X, therefore, carries forward $40 million of the 2018 NOL under the new law (80 percent of $50 million) to offset $40 million of its taxable income in 2019. If the BEAT NOL add-back is based on the BE% for the 2019 tax year, then X would be subject to BEAT of $36.4 million in 2019 as the result of the $40 million of base erosion payments made in 2018. However, if the BEAT NOL add-back is based on the BE% for the 2018 tax year, then X would be subject to $9 million of BEAT.

Example 2					
2018			**BE% (Current Year vs. Loss Year)**		
Gross Income	$ 600.00		If 2018, then BE % =	23%	(150/650)
Related Party Deductable Payments	$ (150.00)		If 2019, then BE % =	91%	(500/550)
Unrelated Party Deductible Costs	$ (500.00)				
Adjusted Taxable Income	$ (50.00)		**BEAT effect of NOL**		
			If 2018 BE %, then	9	(40 x 23%)
			If 2019 BE%, then	36.4	(40 x 91%)
2019					
Gross Income	$ 600.00				
Related Party Deductible Payments	$ (500.00)				
Unrelated Party Deductible Costs	$ (50.00)				
Adjusted Taxable Income	$ 50.00				
s172 NOL carryforward (80%)	$ (40.00)				

Lastly, assume for tax year 2018 that taxpayer X generates $600 million of gross income, makes deductible payments non-related party payments of $650 million, and no other deductions, thereby generating an NOL of $50 million and, based on 2018 deductions, a BE% of 0%. Further, assume that in 2019 taxpayer X generates $600 million of gross income, makes deductible non-related party payments of $50 million, and deductible base erosion payments of $500 million, thereby generating $50 million of taxable income and, based on 2019 deductions, a

BE% of 91%. X, therefore, carries forward $40 million of the 2018 NOL under the new law (80 percent of 450 million) to offset $40 million of its taxable income in 2019. If the BEAT NOL add-back is based on the BE% for the 2019 tax year, then X would be subject to BEAT of $36.4 million in 2019 as the result of the $40 million of deductions taken in 2018. This result seems particularly egregious considering X would have met the BE% safe harbor during 2018 (i.e., its BE% is below 3%), yet X is required to add-back a portion of its NOL as a BEAT add-back in 2019!

However, if the BEAT NOL add-back is based on the BE% for the 2018 tax year, then X would be subject to zero (0) BEAT as a result of the NOL add-back which is also consistent with the fact X would not be subject to BEAT in 2018 due to the fact its BE% was below the 3% safe harbor.

Example 3					
2018			**BE% (Current Year vs. Loss Year)**		
Gross Income	$ 600.00		If 2018, then BE % =	0%	(0/650)
Related Party Deductable Payments	$ -		If 2019, then BE % =	91%	(500/550)
Unrelated Party Deductible Costs	$ (650.00)				
Adjusted Taxable Income	$ (50.00)		**BEAT effect of NOL**		
			If 2018 BE %, then	0	(40 x 0%)
			If 2019 BE%, then	36.4	(40 x 91%)
2019					
Gross Income	$ 600.00				
Related Party Deductible Payments	$ (500.00)				
Unrelated Party Deductible Costs	$ (50.00)				
Adjusted Taxable Income	$ 50.00				
s172 NOL carryforward (80%)	$ (40.00)				

As highlighted in the examples above, applying the BE% for the year in which a loss occurs would result in a better and clearer reflection of the taxpayers BEMT because it correlates the BEAT component of the NOL carryover to the facts applicable in the year it was created and thus ensures that all base erosion payments that are part of the NOL that offset gross income in the carryover year (not more or less) are included in the computation of MTI for that year. Furthermore, it alleviates the situation where a NOL from a non-BEAT taxpaying year becomes a BEAT add-back due to facts not present at the time the loss was incurred.[1]

To simplify the reporting and administrative complexity associated with requiring taxpayers to calculate their BE% based on the year the loss was incurred and not the year when it is applied, the IRS should ensure the BE% allocable to the NOL carryover is captured on the applicable FORM supporting the taxpayer's BEAT calculation and filed with the taxpayer's tax return. For pre-2018 NOL carryovers, no BEAT add-back should be required as discussed under (B) below.

B. Application of BEAT to pre-TCJA NOLs

Because the BEAT applies only to "base erosion payments" that are "paid or accrued" in taxable years beginning after 2017, BEAT should not apply to base erosion payments that were paid or accrued in taxable years beginning prior to 2018, even if they resulted in an NOL carryforward.

Based on the statutory definition of "base erosion payment" in section 59A(d), a carryover of a pre-2018 NOL into a post-2017 taxable year does not create a base erosion payment that is treated as paid or accrued in a post-2018 taxable year. Rather, the carryover of the pre-2018 NOL simply creates a separate deduction for an NOL equal to

[1] It should be noted that neither approach addresses the situation where a taxpayer carries an NOL from a year the taxpayer is subject to BEAT into a year when the taxpayer is not subject to BEAT. In either case, the taxpayer will have no BEAT exposure.

the amount of the carryover. The rules in section 172 do not disaggregate the deduction for the NOL into components that include a deduction for a base erosion payment paid or accrued in the year to which the NOL is carried. Thus, the same effective date treatment should apply to any portion of an NOL that relates to pre-2018 base erosion payments as to a pre-2018 base erosion payment itself. That is, neither should be subject to BEAT.

If Congress had intended to apply BEAT retroactively to payments that were paid or accrued in pre-effective date years due to a NOL carryover, or otherwise, it could have provided that BEAT is effective for any post-2018 base erosion payment and for the base erosion percentage of any net operating loss deduction allowed under section 172 for a post-2018 taxable year. Rather, it applied BEAT only to base erosion payments that are paid or accrued in taxable years beginning after 12/31/17 and provided for no special rules for payments that were paid or accrued in taxable years prior to 2018 that might be deducted under section 172 in a post-2017 year.

The tracing approach discussed above under Issue 1 further supports and highlights the necessity for this interpretation. As explained above, one possible reason for the add back to the BE% of an NOL deduction was to prevent deductions for base erosion payments that did not offset gross income in the year the NOL arose (because there was insufficient gross income to offset) from offsetting gross income in a year in which BEAT was effective without being subject to BEAT. As illustrated in the examples above, adding back the BE% amount in the year to which the NOL is carried does not produce a rational result as such BE% is not correlated to the base erosion payments that generated the NOL. In particular, Example 3 highlights the policy disconnect and general unfairness that would result from a decision to treat an NOL from a non-BEAT tax year as a BEAT add-back in a subsequent year due to facts completely unrelated to the generation of the NOL and thus to the amount of base erosion payments that offsets gross income in the year as a result of the NOL carryover. Likewise, if in the year that the NOL arose there were no base erosion payments to which the BEAT rules applied, because the payments were paid or accrued in pre-2018 years, then the result should be that the relevant BE% for that NOL is zero. The MTI add back rules should apply only to NOLs that are generated in taxable years beginning after 12/31/2017.

As discussed above, there are sound policy reasons to conclude the BE% should be based on the taxpayer's deductions in the year the NOL was created. Notwithstanding, if a decision is taken otherwise for administrative ease, in no event should a pre-tax reform NOL be included as an addback because the section 59A effective date precludes application of the BEAT to payments prior to December 31, 2017. Furthermore, a pre-2018 NOL deduction itself is not a separate and distinct base erosion payment in the year it is utilized, but rather the reflection of costs paid or accrued in a pre-tax reform year.

Applying the prior year BE% even though the payments in such year did not constitute base erosion payments, as the statute was not effective with respect to such payments, would be tantamount to applying the rules retroactively, in contravention of the effective date rule Congress adopted. Moreover, it would mean that taxpayers would have to go back, potentially 19 years (pre-2018 NOLs can be carried forward for 20 years), to determine the BE%, even though at the time of the payment the BEAT rules were not effective.

Given that BEAT is intended to be a base erosion anti-abuse tax, no sound policy justification supports requiring taxpayers to add back the BE% of pre-2018 NOLs. By definition, base erosion payments that formed part of NOLs generated in such years were not subject to BEAT. Thus, requiring taxpayers to be potentially subject to BEAT because of such prior payments does not deter any anti-abuse behavior that BEAT might have been intended to address. Rather, it serves only to penalize taxpayers unfairly for following the laws then in force in prior years. Moreover, the pre-2018 NOL deductions reduce regular tax liability, thereby increasing the likelihood that BEAT applies to cause current year base erosion payments to be subject to BEAT.

C. Distinguishing the treatment of NOLs and interest expense carry forwards

Notwithstanding arguments to exclude pre-2018 interest deductions deferred under section 163(j) from BEAT, the recommendation for the treatment of pre-2018 NOLs is distinguishable because of the specific statutory

language under both old and new section 163(j), language which is absent from sections 59A and section 172. If however, a decision is taken to exclude pre-2018 deferred interest deductions under section 163(j) from the BEAT, such a decision would further support the treatment of pre-2018 NOLs discussed above.

In Notice 2018-28, Treasury/IRS announced that they plan to issue regulations that would provide that pre-2018 payments or accruals of interest for which deductions were deferred under old section 163(j) would carry over and be treated as "paid or accrued" in post-2017 years and would thus be subject to both the newly amended section 163(j) and BEAT. Unlike BEAT, under prior law section 163(j) (as well as under newly amended section 163(j)), interest deductions which are denied in the year the interest expense is paid or accrued is treated as "paid or accrued . . . in the succeeding taxable year." Thus, section 163(j) mandates that such interest expense is treated as "paid or accrued" in the year to which the deduction is carried and in which it is allowed. Accordingly, when Treasury/IRS announced that they intended to write regulations providing that interest deductions that were deferred under section 163(j) at the end of the last taxable year beginning before 12/31/2017 would carry over, they explained that, since the rules treat interest expense as "paid or accrued" in the year to which the deduction is carried, such interest expense is treated "in the same manner as any other business interest otherwise paid or accrued in a taxable year beginning after December 31, 2017."

Section 163(j) mandates that interest expense for which a deduction was deferred be treated as "paid or accrued" in the year to which the deduction is carried. By contrast, an NOL carryover does not result in any portion of the NOL being treated as a base erosion payment that is paid or accrued in the year to which the NOL is carried. Rather, the carryover of the pre-2018 NOL under section 172 simply creates a separate deduction equal to the amount of the carryover. Thus, there is no technical basis, as in the case of the deferral of a deduction for interest under section 163(j), to treat the NOL deduction itself as a base erosion payment that is paid or accrued in a post-2017 year.

CONCLUSION:

To ensure the outcomes discussed above are achieved, regulations for the BEAT should be written to clarify:

(1) The NOL add back should be based on the post-effective-date BE% in the year the NOL arose, and

(2) The BEAT add back for pre-TJCA losses carried into a post-TCJA year should be zero.

This outcome is distinguishable from the proposed treatment of pre-2018 interest deductions deferred under section 163(j).