COVINGTON

BEIJING BRUSSELS DUBAI FRANKFURT JOHANNESBURG
LONDON LOS ANGELES NEW YORK PALO ALTO
SAN FRANCISCO SEOUL SHANGHAI WASHINGTON

Covington & Burling LLP
One CityCenter
850 Tenth Street, NW
Washington, DC 20001-4956
T +1 202 662 6000

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VIA HAND DELIVERY AND FEDERAL eRULEMAKING PORTAL

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

William M. Paul, Esq.
Acting Chief Counsel and Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Section 59A Proposed Regulations (Internal Revenue Service REG–104259–18) – Applicability of BEAT to Global Services Provided by U.S. Equipment Manufacturers

Dear Messrs. Kautter, Rettig, and Paul:

Covington & Burling LLP appreciates the opportunity to submit comments on the proposed regulations under section 59A (the "Proposed Regulations").[1]

I. Introduction

U.S.-based equipment manufacturers often provide installation, maintenance, and repair services to customers around the world ("equipment services") as an integral part of their business. Providing these services supports ongoing manufacturing in the United States by facilitating both original sales of the manufacturer's equipment and sales of replacement parts. This letter recommends guidance addressing the risk that certain payments by U.S. manufacturers to foreign affiliates that provide equipment services could be classified as base erosion payments for purposes of the base erosion minimum tax imposed by section 59A (the "BEAT"), which if applicable would severely disadvantage U.S. manufacturers.

[1] Unless otherwise specified, references to "sections" herein are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder, as indicated.

Payments for equipment services provided to customers outside the United States should not be treated as base erosion payments within the intendment of the BEAT. As explained below, such payments do not erode the U.S. tax base, but instead facilitate U.S. manufacturing, thereby enhancing the U.S. tax base. Such payments may be excluded from base erosion treatment by other applicable rules, but uncertainties as to the scope of those exclusions may create needless administrative burden and controversy. To avoid such uncertainty and controversy, and to promote consistency, we recommend that Treasury and the IRS issue guidance clarifying that payments to affiliates for equipment services provided directly to third-party customers outside the United States are not base erosion payments.

Part II provides an overview of the fact pattern at issue. Part III explains why equipment services payments are not base eroding payments in light of the language and purpose of section 59A. Part III also finds support for this view based on technical and administrative considerations under related tax rules, and concludes by addressing the adverse economic impacts of potential "self-help" remedies if clarification is not provided. Part IV sets forth a proposed regulatory solution to the issue and describes the authority for that solution.

II. Equipment Services are Integral to Sales by U.S. Equipment Manufacturers

Equipment used in a business typically requires maintenance and repair to keep it operating. While equipment purchasers are generally free to obtain such services from independent providers, many customers prefer to receive services from the manufacturer that produced the equipment. Third-party service providers may find it hard to match the manufacturer's depth of knowledge and experience with respect to the equipment that it produces. Based on its expertise, the manufacturer is frequently able to deliver more consistent service quality and greater predictability of costs. In addition, manufacturers can often provide greater variety and flexibility in their service offerings, given the scope of their service operations. Customer preferences for a manufacturer's service offerings tend to be particularly strong in the case of large or complex equipment, or with respect to equipment used in activities subject to government regulation, as the manufacturer's expertise is particularly critical in such cases. For many equipment manufacturers, providing ongoing services to customers contributes significantly to success in selling equipment and replacement parts, and is thus an integral part of their manufacturing business models.

Many U.S.-based manufacturers conduct their principal manufacturing operations in the United States, while selling their products to a worldwide customer base. The need to provide ongoing maintenance and repair services to worldwide customers generally means that U.S.-based manufacturers must provide such services on a global basis, at locations convenient to customers. The global mix of service locations is typically based on a combination of customer locations, supplier locations, ability to compete with foreign-based manufacturers on cost, and other business considerations. In sum, a U.S.-based manufacturer with a global customer base typically finds it necessary to provide equipment services around the world.

Customers often seek a single service contract for ongoing equipment services, generally negotiated in connection with the purchase of the equipment, and many U.S.-based manufacturers manage their global services programs as an outgrowth of their manufacturing operations in the United States. Thus, in the typical customer service arrangement, a U.S.

affiliate will contract with the customer, maintain the customer relationship, and manage the provision of services, while subcontracting with domestic and foreign affiliates as needed to provide required services at locations within the United States, outside the United States, or both.[2]

Under these arrangements, the customer has its contractual relationship with, and makes payments to, the service operation's U.S. headquarters company, regardless of whether U.S. affiliates, foreign affiliates, or both, are expected to provide the required services. The U.S. headquarters company in turn pays U.S. and foreign affiliates for the respective services that they provide to the customer. Under this business model there is a direct service relationship (albeit not contractual privity) between the third-party customer and the service-provider affiliate, as services are provided directly to the customer by the affiliate at its service location. This structure enables the group to manage and control its global services operations from within the United States, as an outgrowth of, and in close coordination with, its U.S. manufacturing activities. Thus, the U.S. manufacturer's U.S.-headquartered global services business model creates both tax base and employment opportunities within the United States.

Historically, this contracting model worked efficiently from a business perspective, and created no notable difficulties for tax purposes: customer revenues flowed to the U.S. headquarters and were then paid out to the U.S. and foreign service providers, with the U.S. headquarters retaining an arm's length profit for its management and control functions, as well as protecting the manufacturing base for spare parts installed by its affiliates.[3] However, this paradigm would be fundamentally changed if the U.S. headquarters, rather than paying tax on its arm's length profits, were subject to BEAT liability on the outbound disbursement of service fees to its affiliates. If it applied, BEAT would impose U.S. tax on an amount that exceeds the U.S. headquarters' income from the transaction, and in fact, by denying a deduction for payments to affiliates that compensate the affiliate for expenses incurred in performing services, would tax an amount greater than the entire group's economic income from performing those services.[4] Moreover, to the extent that the service fees were also taxed in the service affiliate's

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[2] Although corporate structures obviously vary from company to company, for convenience we generally refer to the U.S. affiliate that manages and controls the group's global equipment services activities as the service operation's "U.S. headquarters." That entity may be the group's parent company, or it may be some other member of the U.S. group, but that detail does not affect the analysis described here.

[3] In some cases, the service-providing entities may be joint ventures between the U.S. manufacturer and an unrelated foreign manufacturer or customer, which underscores the business realities (and arm's-length nature) of a structure in which services are contracted and managed through a U.S. headquarters and performed globally. Indeed, in some instances U.S. manufacturers utilize unrelated foreign service providers to deliver required services, when necessary.

[4] For example, assume that a U.S. headquarters and foreign affiliate as a group earn $100x for services and incur $80x in expenses (mostly in the affiliate) to carry out those services, such that the group-wide economic income is $20x. But if the United States were to impose income tax on the spread retained by the U.S. manufacturer (say $5x) and also treat as a base erosion payment the service fees paid on to the sub ($95x), then the United States would

country of operation, the taxpayer would bear unrelieved double taxation, with virtually no access to foreign tax credits.[5] Thus, imposing BEAT liability in these circumstances would make the successful global services model currently employed by many U.S. manufacturers wholly unsustainable.

Based on the analysis that follows, however, equipment services payments should not be treated as base erosion payments.

III. Equipment Services Payments Are Not Base Erosion Payments

A. Statutory Language and Purpose

The operative language of section 59A makes clear that the statute's focus is on payments that erode the U.S. tax base. For example, the rule's application is triggered when "base erosion payments" give rise to "base erosion tax benefits." The regulatory implementation of these terms should apply them in a manner that rationally distinguishes between deductible payments that are what the statute by its terms seeks to tax – base erosion payments – and those that are not. And indeed, the Proposed Regulations adopted precisely that approach, by providing regulatory exceptions for amounts that would otherwise fall within the statutory definition of a base erosion payment, based on determinations by Treasury and the IRS that certain payments do not present base erosion concerns.[6]

Further, limiting the term "base erosion payment" to payments that erode the U.S. tax base is supported by the legislative history's clear focus on base erosion as the particular abuse targeted by the provision. The Senate Finance Committee, which introduced the BEAT as an alternative to a House provision addressing similar concerns, framed its explanation of the reasons for a change in law as follows:

> Foreign-owned U.S. subsidiaries are able to reduce their U.S. tax liability by making deductible payments to a foreign parent or foreign affiliates. This can erode the U.S. tax base if the payments are subject to little or no U.S. withholding tax. Foreign corporations often take advantage of deductions from tax liability

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impose tax on a total amount ($100x) that exceeds not only the U.S. parent's real income ($5x) but also the system-wide economic income ($20x). We recognize that at some level this could be viewed as an intended effect of the statute, based on general suspicion of the bona fides of payments to foreign related parties. But where, as here, the fees represent genuine expenses incurred in a substantial service business, the application of the BEAT to tax significant amounts of non-economic income would quickly make this global services business model unworkable for U.S.-based manufacturers.

[5] Even if foreign tax credits were otherwise available, for example under section 960(d), the BEAT computation would effectively deny the use of such credits.

[6] See further discussion of the Proposed Regulation's exceptions in section IV.B, below.

> in their U.S. affiliates with payments of interest, royalties, management fees, or reinsurance payments. [Section 59A] aims to tax payments of this kind. This type of base erosion has corroded taxpayer confidence in the U.S. tax system.[7]

The legislative history thus made clear, consistent with the language of the statute itself, that the Senate Finance Committee's focus in drafting section 59A was to combat base erosion.

Given the consistent focus of the statute and the legislative history on base-eroding payments, it is critical to recognize that the equipment services payments addressed here are not base eroding. The manufacturing activity and associated profits remain in the United States, and are undiminished by the flow of global services payments through the services operation's U.S. headquarters. Income from services performed in the United States likewise remains in the U.S. tax base. And the income of foreign affiliates from services performed for customers outside the United States was never properly part of the U.S. tax base under basic principles. Accordingly, payments from customers for non-U.S. services that flow through a U.S. headquarters operation to the foreign affiliate providing the services do not in any sense erode the U.S. tax base. This recognition that the income from services provided by foreign affiliates to customers outside the United States is not properly within the U.S. tax base informs the design of the regulatory solution suggested below, which keys off the geographic location of both the service provider and of the equipment that it services.

The absence of any base erosion in relation to the payments at issue is underscored by the conduit nature of the payment flows in relation to services provided by foreign affiliates, which reflect the U.S. headquarters' back-to-back contractual relationships with the service-recipient customer and the service-provider affiliate. Those contractual relationships reflect the U.S. entity's headquarters role, but not a role as a direct provider of customer services. The U.S. headquarters manages global customer services relationships, facilitating the flow of services and payments among global customers and the affiliates that provide services directly to those customers, including both U.S.-based and foreign-based service-providers. If instead the global services coordination role were performed by a non-U.S. affiliate outside of the United States, the identical contractual arrangements and payments would present no BEAT issues at all. But notwithstanding the absence of any genuine erosion of the U.S. tax base, the U.S. headquarters' receipt and on-payment of customer service fees would potentially trigger BEAT liability, if the

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[7] Senate Finance Committee Explanation of the Bill, Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71*, S. Prt. 115-20, at 391 (Dec. 2017) (*hereinafter*, the "Senate Finance Committee Explanation"). *See also* H.R. Rep. No. 115-409, at 400 (Nov. 13 2017) (*hereinafter*, the "House Report") ("[U]nder the current system, companies have been able to base erode by making outbound, related-party deductible payments."); 163 Cong. Rec. S8107 (Dec. 19, 2017) (statement of Sen. Lindsey Graham) ("[B]ase erosion payments do not include amounts paid to a foreign affiliate that are subject to U.S. income tax . . . [t]he income has not been shifted offshore, and there has been no erosion of the tax base."); Ways & Means Committee Majority Tax Staff, Tax Cuts & Jobs Act H.R. 1 Section-by-Section Summary, at 73 (*hereinafter*, the "House Section-by-Section Summary") ("Multinational enterprises, and particularly foreign-parented multinational enterprises, can erode the U.S. tax base by shifting profits to foreign affiliates . . .").

outbound payment to a foreign affiliate were a base erosion payment under a reading of the statute that ignored the fact that the payment is not actually base eroding.

Accordingly, adding a U.S. participant to what is otherwise a foreign-based transaction outside of U.S. taxing jurisdiction should not be treated as eroding the U.S. tax base. Further, the business-driven character of these global services arrangements, and their economic reality, is underlined by the fact that often the relevant foreign service providers are joint venture entities with unrelated foreign manufacturers or customers, a structure in which pricing manipulation or other tax-motivated abuses are unlikely to arise. Indeed, as noted above, in some cases the service providers are wholly unrelated, and clearly do not trigger BEAT liability. Thus, the existence of largely identical equipment services arrangements with wholly-owned, joint venture, and unrelated counterparties underlines how anomalous it would be to treat payments for foreign-based equipment services as base erosion payments.

As discussed above, the issue addressed here arises because a U.S. participant is inserted into what is otherwise a foreign-based economic relationship between a foreign affiliate and a customer. While it would be anomalous in the first place to treat non-base eroding payments by that U.S. participant as if they were base erosion payments, the anomaly would be particularly acute given that the legislative history reflects Congress' focus on base-eroding opportunities for foreign-owned U.S. companies, and in particular on those companies' deductions of certain expenses that may be prone to manipulation, such as "interest, royalties, management fees, [and] reinsurance payments."[8] The focus on foreign-owned companies in the legislative history underscores the incongruity of subjecting *U.S.-headquartered* equipment manufacturers to BEAT liability based solely on the headquarters' receipt and disbursement of service fees paid by third-party customers for services physically performed outside the United States. By contrast with intragroup transactions that do not involve arm's length payments from third-party customers, and that may be manipulated to erode the U.S. tax base, the U.S. headquarters structure could alternatively have been arranged from the beginning so that the foreign service-providing affiliates contracted directly with customers and received payment for services directly from those customers, a structure that would have presented no BEAT issues whatsoever. Thus, the U.S.-headquartered equipment services structure described above actually *enhances* the U.S. tax base, because the structure layers a U.S. headquarters function – and associated high-paying jobs – onto what could otherwise be a transaction directly between a foreign service provider and a third-party customer.

We acknowledge that Congress did not limit the application of section 59A solely to foreign multinationals. In addition to the broad base erosion concerns articulated directly above, the legislative history also reflects that Congress had concerns about both foreign and U.S. multinationals outsourcing jobs "at the expense of the American worker."[9] However, as

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[8] Senate Finance Committee Explanation at 391.

[9] *Id.* As noted above, a company's global mix of service locations is typically based on business considerations that include customer locations, supplier locations, and ability to compete with foreign-based manufacturers on cost. Thus, when the global reach of a company's services operations matches the global reach of its customer base, that

articulated by both the Senate Finance Committee and the House Ways and Means Committee, the purpose of including U.S. multinationals within the scope of the BEAT (or the similar House rule) was to create a "level playing field" between U.S. and foreign multinationals.[10] In contravention of that stated purpose, subjecting U.S. manufacturers to BEAT liability on the payments described above would not level the playing field but would instead penalize U.S. manufacturers. By contrast, a manufacturer with a similar but foreign-headquartered equipment services arrangement would suffer no BEAT liability (and very likely no comparable liability under its home-country tax rules). Rather than leveling the playing field, this disparate treatment would put U.S. manufacturers at a significant disadvantage in comparison to their foreign competitors, a particularly perverse result given the purpose of the statute. Moreover, the particular payments by U.S. multinationals that troubled Congress, and led to inclusion of U.S.-headquartered companies within the scope of the BEAT, were those made to foreign affiliates for *intercompany* services[11] – in contrast to the payments at issue here, which are for services provided to unrelated customers.

Accordingly, both the statute's language and its legislative history support implementing the definition of a base erosion payment so as to take into account whether or not particular payments in fact erode the U.S. tax base, and in particular support a regulatory rule clarifying that the equipment services payments described above are not base erosion payments.

B. Technical and Administrative Considerations Support Clarifying that Equipment Services Payments Are Not Base Erosion Payments

In addition to being an appropriate implementation of the statutory language and legislative history of section 59A, a regulation clarifying that equipment services payments are not base erosion payments would provide certainty and avoid needless controversy under related bodies of law that are potentially relevant to the BEAT analysis.

Authorities based on conduit, agency, and similar principles often evaluate the true payor with respect to a particular payment stream. As acknowledged by the preamble to the Proposed Regulations, such authorities will be relevant to determine whether a taxpayer has

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should not be considered an outsourcing of U.S. jobs of the type that concerned Congress. To the contrary, because global services operations facilitate the sale of U.S.-manufactured equipment and parts to non-U.S. customers (and to U.S. customers that operate internationally), such operations promote U.S. manufacturing activities and U.S. jobs.

10 Senate Finance Committee Explanation at 391; Ways & Means Section-by-Section Summary at 74.

11 House Report at 400. The House Report stated that U.S.-parented multinationals often make "outbound payments to remunerate foreign affiliates for tangible goods or intercompany services." *Id.* The version of the legislation upon which the House Report was based did not provide an exemption for COGS, so payments to foreign affiliates for goods were within the purview of the then-contemplated excise tax. The changes made in the Senate version of the bill, which by its structure exempts from BEAT liability payments that constitute COGS, should not have affected Congress's overall concern, with respect to U.S. multinationals, with payments for intercompany services.

made a deductible payment subject to the BEAT. For example, case law provides that if an intermediary serves as a mere waystation for disbursement of a payment from one party to another, and the intermediary is in fact obligated to pass through the payment to the designated recipient, temporary custody of the payment does not result in taxable income – or an offsetting deductible payment – to the intermediary.[12] In the equipment services fact pattern described above, the U.S. headquarters may be viewed as such a waystation, facilitating the disbursement of payments from global customers to foreign service providers. To the extent that the U.S. headquarters is obligated to pass those payments through to the foreign service providers, common law authorities may apply to prevent the U.S. headquarters from recognizing income and an offsetting deduction. However, uncertainties regarding the scope of this common law doctrine could lead to unnecessary administrative burden and controversy regarding its application in particular circumstances. And regardless of the technical scope of the doctrine, its close analogy to the back-to-back contractual arrangements at issue here provides support for excluding such payments from BEAT liability.

The intersection of the service payments at issue here with the cost of goods sold (“COGS”) rules similarly reinforces that conclusion. If a U.S. corporation pays its foreign affiliates for component parts, the payment is part of COGS and is excluded from BEAT liability.[13] But while costs treated as part of COGS may include the costs of some services, uncertainties regarding the appropriate scope of such treatment could again be the source of needless administrative burden and controversy regarding its application in particular circumstances. Moreover, regardless of the technical scope of COGS treatment as an accounting matter, the costs of the equipment services addressed here are in key respects functionally equivalent to COGS payments: (i) they are payments for services that are integral to the manufacturer’s ability to sell products to its customers, and (ii) the services provided are in a real sense an extension of the U.S. parent’s manufacturing activities. Maintenance requirements often necessitate disassembly and rebuilding of equipment, and involve significant replacement and reconditioning of parts. Accordingly, the possibility that some equipment service payments may be treated as COGS, combined with such payments’ broader similarity to COGS, would make it particularly anomalous to treat them as base erosion payments.

In sum, both the conduit authorities and the COGS rules bolster our conclusion that a U.S. headquarters’ payments for equipment services rendered to third-party customers are not

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[12] *See, e.g.*, *Affiliated Foods, Inc. v. Commissioner*, 128 T.C. 62, 79 (2007); *Florists’ Transworld Delivery Ass’n v. Commissioner*, 67 T.C. 333, 346 (1976); *Ford Dealers Advertising Fund, Inc. v. Commissioner*, 55 T.C. 761, *nonacq.*, 1974-2 C.B. 1, *aff’d*, 456 F.2d 255 (5th Cir. 1972) (*per curiam*); *Seven-Up Co. v. Commissioner*, 14 T.C. 965, 979 (1950), *acq. in result*, 1974-2 C.B. 4.

[13] *See* Conference Report to accompany H.R. 1, H.R. Conf. Rep. No. 115-466, at 532 (Dec. 15 2017) (payments that reduce gross income, including payments for COGS, are not base erosion payments).

base erosion payments. Accordingly, we recommend inclusion in the final regulations of a provision clarifying that payments for such services are not base erosion payments.[14]

C. Self-Help Solutions Would be Problematic for Taxpayers and the Government

Without relief from non-economic taxation under the BEAT (including potential double taxation), U.S. manufacturers that manage global services from the United States would be disadvantaged by comparison with taxpayers using services structures that are only marginally different as a substantive matter, but that suffer no BEAT exposure. The fact that the underlying transactions could avoid the BEAT altogether if they were structured in ways that do not significantly change the parties' economic relationships provides further confirmation that the economics of the existing contractual terms simply do not create base erosion within the intended scope of section 59A.

For example, if a taxpayer maintains the headquarters functions related to its global equipment services operations in a non-U.S. affiliate, no BEAT liability would arise even if the contractual arrangements were otherwise identical. The identical contractual services payments from customers to headquarters and then on to non-U.S. services providers would be entirely BEAT-free, because the foreign affiliate serving that headquarters function would make no deductible payments for U.S. tax purposes. But when U.S. manufacturers utilize such a foreign-headquartered structure, this not only reduces the U.S. tax base – by eliminating U.S. tax on the return to the headquarters and marketing functions – but also eliminates high-paying U.S. headquarters jobs, thus undercutting not one but two of the primary purposes of the BEAT regime.[15]

Similarly, customer contractual arrangements that run directly between global customers and the U.S. manufacturer's non-U.S. service-provider affiliates are likewise BEAT-

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[14] We recognize that the Proposed Regulations would appropriately implement the statutory exception for services eligible for the services cost method ("SCM"). However, that exception would not reliably apply to clarify the treatment of equipment services. The SCM exception excludes from BEAT liability certain amounts paid or accrued for services eligible for the SCM under the section 482 regulations. Qualification for the SCM requires, *inter alia*, that the services qualify as either "specified covered services" or "low margin covered services" within the meaning of Treasury regulation section 1.482-9(b)(3). The list of specified covered services that qualify for the SCM method are support services that are administrative in nature; the installation, maintenance, and repair services at issue here would generally fall outside the scope of those enumerated support services. Moreover, the substantive services contemplated here frequently involve arm's length profit margins in excess of the seven percent limit on low margin covered services. For those reasons, the SCM exception would often be inapplicable to services provided under a global equipment services model.

[15] *See* Senate Finance Committee Explanation at 391.

free.[16] Such arrangement are not inconsistent with retaining management functions in the United States, separate from the contractual flow. But unless companies had previously adopted this variant, a forced renegotiation of longstanding customer contracts would be disruptive to U.S. manufacturers' business operations and customer relationships. Such forced renegotiations would provide a competitive advantage to foreign manufacturers that do not need to restructure and thus do not face the resulting negative effects on operations and customer relationships; the required restructurings would thus impose a disproportionate impact on U.S.-based multinationals. Moreover, because the scope of any business disruptions to a U.S. manufacturer would depend largely on the terms of its existing contractual arrangements, forced renegotiation would result in disparate effects on otherwise similarly-situated taxpayers. For example, taxpayers in industries with longer duration contracts would be disproportionately hurt due to the increased complexity of renegotiating long-term arrangements.[17] Indeed, in some industries with longer duration contracts, it may be infeasible to renegotiate existing contracts on economically viable terms.

In light of the complexities and business disruptions identified above, these alternative structures should not be considered viable self-help solutions to the non-economic taxation faced by U.S. manufacturers under the BEAT in the circumstances addressed here. And even if these restructuring paths *were* considered practicable options, the nominal availability of the options does not justify an implementation of the statute that is inconsistent with its language and purpose, and that moreover leads to a loss of U.S. tax revenue and U.S. jobs. Accordingly, to avoid the business disruptions, long-term revenue loss, and loss of U.S. jobs that would arise if U.S. manufacturers were forced to restructure to avoid double taxation under an inappropriate application of the BEAT regime, we recommend the development of regulations that implement the statutory definition of a base erosion payment in a manner that takes into account whether such payments actually result in base erosion. One possible approach is illustrated below.

IV. Suggested Solution

A. Mock-Up of Regulatory Language

As discussed above, to avoid needless uncertainty and potential controversy, and to implement the BEAT in a manner rationally related to its purpose, we recommend that Treasury and the IRS clarify in the final regulations that payments for equipment services are not base

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[16] Formulating the contractual relationships in this manner results in direct payments from customers to foreign service providers, thereby eliminating the income and deduction flows through the U.S. headquarters entity that potentially give rise to BEAT liability.

[17] For example, a single, short-term contractual arrangement for services, such as a concert performance by a musician, could presumably be altered with relative ease on a go-forward basis, while a ten-year or longer maintenance contract for industrial equipment would be likely to require significant renegotiation.

erosion payments in the circumstances discussed above. One possible drafting approach for a bright-line rule would read as follows:

> *[§1.59A-3(b)(3)(viii)]* Payments for Certain Services Provided to Unrelated Parties--(A) In general. Amounts paid or accrued by a taxpayer to a foreign related party if:
>
> (*1*) The payment is for services provided to an unrelated party;
>
> (*2*) The services are performed in connection with tangible property produced by the taxpayer (or a related party) that is located outside the United States when the services are performed; and
>
> (*3*) The services are performed outside the United States.
>
> (B) Examples. The following examples illustrate the rules of this paragraph [(b)(3)(viii)].
>
> *Example (1).* USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation organized in Country X. USP manufactures heavy equipment that it sells to a global customer base. USP enters into installation, maintenance, and repair contracts with unrelated purchasers of its equipment. USP subcontracts with CFC1 to provide the agreed services, and pays CFC1 an arm's length price for providing those services to unrelated purchasers of USP equipment. All services provided by CFC1 are performed outside the United States at a time when the subject equipment is located outside the United States. Accordingly, the payments from USP to CFC1 for the subcontracted installation, maintenance, and repair services qualify for the exception provided by § 1.59A-3(b)(3)(viii)(A) because such payments are (i) for services provided by CFC1 to an unrelated party, (ii) in connection with tangible property manufactured by USP that is located outside the United States when the services are performed; and (iii) for services that are performed by CFC1 outside the United States.
>
> *Example (2).* The facts are the same as in Example (1), except that the services provided by CFC1 are diagnostic analyses performed by CFC1 technicians on a remote basis while the equipment is located in the United States. Because the equipment is located within the United States when the services are performed, the payments from USP to CFC1 for the diagnostic analysis services do not qualify for the exception provided by § 1.59A-3(b)(3)(viii)(A).
>
> *Example (3).* The facts are the same as in Example (1), except that in addition to the services provided to USP customers, CFC1 also provides technical consulting services to USP itself. Because the technical consulting services are not provided by CFC1 to an unrelated party, the

payments from USP to CFC1 for those services do not qualify for the exception provided by § 1.59A-3(b)(3)(viii)(A).

We note that equipment services not treated as base erosion payments by reason of this rule would remain subject to normally-applicable U.S. tax rules that should limit potential opportunities for abuse. For example, because existing transfer pricing rules already require the U.S. manufacturer to include in its U.S. taxable income an appropriate return to its U.S. functions and risks in relation to its global services business, no separate rules should be needed to address that requirement, which should ordinarily leave a level of U.S. profit over and above the amounts paid through to related-party service providers. Similarly, the subpart F base company services rules should ensure that transactions covered by the rule are ordinary-course commercial dealings rather than tax-motivated attempts to shift income among CFCs. Finally, the suggested rule is intended to prevent the inappropriate application of the BEAT to penalize U.S. manufacturing and associated activities, but it is drafted neutrally so that it could potentially apply to a foreign company or its U.S. affiliate, to the extent that either made related party payments that would otherwise be base erosion payments but that satisfied the customer and non-U.S. performance requirements of the rule.[18]

B. Regulatory Authority

The requested relief falls within the scope of the section 59A(i) authority to issue regulations "necessary or appropriate to carry out the provisions of this section." That grant of authority is just as much a part of the statute as its specific rules; and in determining the scope of an appropriate exercise of that authority, it would be anomalous to view the authority as limited by the scope of what Congress specified the authority as "including." The point of such a grant is to provide Treasury with authority to address circumstances not contemplated by the statute itself. While such authority does not, of course, authorize the drafting of a regulation fundamentally at odds with the statute, it must include the authority to implement the statute in a manner consistent with its policy goals, and must logically include the authority to adopt rules not already included in the language of the statute, since otherwise there would be little point in granting such authority.

The suggested rule would implement the statutory definition of the term "base erosion payment" in a manner that, consistent with Congressional intent, excludes payments that were never part of the U.S. tax base. The U.S. tax base is eroded when the income from U.S. economic activity is shifted to another jurisdiction through the use of a deductible payment, whereas the proposed rule would exclude payments related to economic activity conducted outside the United States for global customers unrelated to the U.S. taxpayer. Such an exercise of authority in this case would be similar to the authority exercised by Treasury and the IRS in the Proposed Regulations. For example, the ECI and section 988 exceptions set forth in the

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[18] In relation to foreign-headquartered groups, consideration could be given to limiting the exception to payments that would not have given rise to base company services income in the hands of the recipient if it were a CFC.

Proposed Regulations effectively interpret the term "base erosion payment" to exclude payments that do not erode the U.S. tax base.[19]

Similarly, section 59A(i)(1)(A) authorizes rules that address the "avoidance of the purposes of this section, including through . . . conduit transactions." The authority to ensure that conduit arrangements do not defeat the purposes of the statute can reasonably be read to encompass any regulation that ensures conduit transactions are treated for purposes of section 59A in a manner that is consistent with the statutory purpose – in other words, the authority granted is not limited to the drafting of anti-taxpayer rules. Thus, that authority also supports implementing an exception to the term base erosion payment for transactions in which the U.S. payor plays an intermediary role between a foreign purchaser and foreign service provider. Notably, the TLAC exception from the definition of "base erosion payment" provides an exception that applies to transactions in which a payment that could otherwise be a payment between unrelated parties is for regulatory reasons passed through a related intermediary.

Thus, the Proposed Regulations reflect a regulatory approach in which amounts otherwise constituting base erosion payments are appropriately excepted from such treatment when not properly viewed as base eroding payments. One example of such treatment, clearly reflected in the ECI exception, is that an amount should not be considered base-eroding when it remains in the U.S. tax base. Another illustration of such treatment, consistent with the TLAC exception, recognizes that a payment is not base eroding if it is a third-party payment passing through a related intermediary. Such a conduit-based rationale should be equally applicable here; that is, the equipment services payments addressed here are pass-through payments that move third-party services payments to related service providers. While the particulars of the payment flows differ,[20] the same fundamental dynamic is at work both here and in relation to TLAC: in both cases the real payment flow is between the taxpayer and an unrelated party, and because the payments are not in substance related-party payments of the type targeted by the statute, they are appropriately excluded from treatment as base erosion payments. Accordingly, a conduit analysis confirms the conclusion that equipment services payments flowing from unrelated customers through a U.S. headquarters to a foreign service provider are not eroding the U.S. tax base. Indeed, the effect of the funds flowing through the U.S. headquarters is actually revenue positive, because the U.S. headquarters retains a profit for its management role. Adoption of the recommended exception would preserve parity of treatment with taxpayers that conduct similar headquarters functions through non-U.S. affiliates, and would obviate the need to consider commercially disruptive restructurings to achieve such parity.

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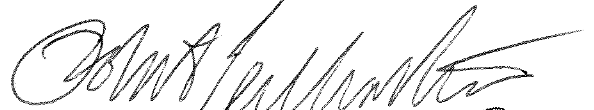
[19] *See* 83 Fed. Reg. 65963.

[20] In the TLAC case, the payment by the U.S. taxpayer flows through a related foreign recipient to an ultimate third-party lender, while in this case third-party customer service revenue flows through the U.S. headquarters entity to the foreign affiliate that provides the services.

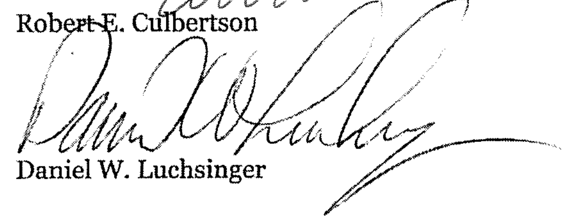
We appreciate the opportunity to submit this letter for your consideration, and we would be happy to develop more fully any of the analysis and discussion presented herein or to further consider the application of the analysis to particular scenarios. We would welcome the opportunity to discuss the issues in this submission.

Sincerely,

Michael J. Caballero



Robert E. Culbertson



Daniel W. Luchsinger

cc: U.S. Department of the Treasury
Lafayette "Chip" G. Harter III, Deputy Assistant Secretary (International Tax Affairs)
Douglas L. Poms, International Tax Counsel
Brian Jenn, Deputy International Tax Counsel
Quyen Nguyen, Deputy International Tax Counsel
Kevin Nichols, Attorney-Advisor, Office of International Tax Counsel

Internal Revenue Service
Drita Tonuzi, Deputy Chief Counsel (Operations)
Marjorie Rollinson, Associate Chief Counsel (International)
Daniel M. McCall, Deputy Associate Chief Counsel (International - Technical)
Karen Walny, Branch Chief, Office of Associate Chief Counsel (International)
Sheila Ramaswamy, Senior Counsel, Office of Associate Chief Counsel (International)