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Reuven S. Avi-Yonah

University of Michigan Law School, aviyonah@umich.edu

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**BEAT IT:
TAX REFORM AND TAX TREATIES**

Reuven S. Avi-Yonah¹

ABSTRACT

The Tax Cuts and Jobs Act (TCJA) includes several provisions that may be viewed as potential violations of US tax treaties. However, most of those potential violations, such as new IRC section 951A and to a large extent new IRC section 59A, are covered by the Savings Clause (US model article 1(4)). The only remaining question is whether IRC section 59A (the “Base Erosion Anti-Abuse Tax”, or BEAT) violates the non-discrimination provision (article 24), which is exempted from the Savings Clause. The answer is no, because foreign related parties are not comparable to US related parties receiving interest or royalties.

1. Introduction: The TCJA and US Tax Treaties

The Tax Cuts and Jobs Act (TCJA), as signed into law on December 22, 2017, includes several provisions that can be seen as inconsistent with US tax treaties. For example, the GILTI rule (new IRC section 951A) imposes tax on the US shareholders of controlled foreign corporations (CFCs) in treaty country in circumstances where the income may be characterized as business profits and where the CFC does not have a permanent establishment (PE) in the United States.

The Base Erosion Anti-Abuse Tax (BEAT, new IRC section 59A) imposes tax on the US related party when it makes deductible payments to a 25% foreign related party. These payments include interest and royalties, some payments for services and reinsurance, and in some limited future circumstances cost of goods sold. Arguably, the BEAT violates Article 9 because it imposes the tax regardless of whether the amount paid is at arm’s length.² It may also be seen as violating articles 11 (interest) and 12 (royalties) and 21 (other income) because it can be viewed as the indirect imposition of a withholding tax. Finally, the BEAT can be viewed as violating article 24 (non-discrimination) because it either disallows deductions that would be allowed if the related party were a US taxpayer, or treats a foreign related party worse than a US related party.

¹ Irwin I. Cohn Professor of Law, the University of Michigan. I would like to thank Steve Shay for very helpful comments on a previous version.

² There is a debate whether article 9(1) imposes a prescription that can be violated; see discussion below.

2. The Savings Clause and Articles 7,9, 11, 12 and 21.

But none of these arguments except for the last one can actually be raised because every US tax treaty has a Savings Clause (usually article 1(4)):

Except to the extent provided in paragraph 5 of this Article, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens.³

The exceptions are not relevant except for article 24 (discussed below).⁴ Thus, no legal argument can be made that GILTI violates article 7 or that BEAT violates article 9, 11, 12 or 21 because in both cases the tax is imposed on the US related party (in the case of GILTI because of the deemed dividend rule of IRC section 951, and in the case of BEAT directly).

Article 9 is potentially different because Article 9(2), the correlative adjustment rule, is excepted from the Savings Clause. But any potential violation of article 9 in the BEAT is a violation of the arm's length standard of article 9(1), which is not excepted from the Savings Clause.

Because the BEAT is applied to the US related party, no direct credit is available for it under the tax laws of the residence jurisdiction. Thus, the BEAT would result in juridical double taxation unless the relevant income is either exempt (which will frequently be the case, see below) or eligible for an indirect credit, which is unlikely because no dividend was distributed. But this potential for double taxation is not a violation of tax treaties. It is equivalent to raising the US effective corporate tax rate by the BEAT, which the US as the residence country of the taxpayer as well as the source country for the relevant income has every right to do under the treaties. The obligation to relieve any double taxation falls on the other treaty partner.⁵

³ US Model (2016), Article 1(4).

⁴ US Model, Article 1(5): The provisions of paragraph 4 of this Article shall not affect: a) the benefits conferred by a Contracting State under paragraph 3 of Article 7 (Business Profits), **paragraph 2 of Article 9** (Associated Enterprises), paragraph 7 of Article 13 (Gains), subparagraph (b) of paragraph 1, paragraphs 2, 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support), paragraph 3 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), **24 (Non-Discrimination)** and 25 (Mutual Agreement Procedure); [...] (emphasis added).

⁵ Relief can be either in the form of exempting the relevant income or by granting a credit for the tax (including the BEAT increase) once the underlying income is distributed as a dividend. When the related foreign party is a CFC, the US effectively grants relief for the BEAT by exempting a dividend to the US parent or by granting the US parent a credit under section 960 if the underlying earnings of the CFC

I have argued elsewhere that the arm's length standard of article 9 can be viewed as customary international tax law and binding even if there was no treaty.⁶ But this does not mean that the ALS can be binding where there is a treaty and a specific treaty provision (the Savings Clause) operates to exclude a US tax from the scope of the treaty. Explicit US legislation always overrides customary international law.⁷

3. Non-Discrimination (Article 24).

The interesting question in regard to the BEAT is therefore whether it can be seen as violating the non-discrimination provision of article 24, because that provision is not subject to the Savings Clause.

Article 24 has two relevant provisions. Under Article 24(4),

Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 7 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned Contracting State. [Emphasis added]

Does the BEAT violate this provision? I would argue that it does not, because the BEAT is not equivalent to the denial of a deduction. Interest, royalties, and the other items covered by the BEAT remain fully deductible. Instead, the tax benefit conferred by deducting them is subject to the 10% BEAT. The non-equivalence of the BEAT and denying the deduction can be seen from the fact that denying a deduction would increase the tax on the deductible item by 21%, not by 10%.

trigger tax under GILTI. The same rules should apply when the foreign related party is the parent.

⁶ Avi-Yonah, Altera, the Arm's Length Standard, and Customary International Tax Law, 39 MJIL Opinio Juris 1 (2017).

⁷ Paquete Habana, 175 U.S. 677 (1900) ("International law is part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction as often as questions of right depending upon it are duly presented for their determination. For this purpose, **where there is no treaty and no controlling executive or legislative act or judicial decision**, resort must be had to the customs and usages of civilized nations...") (emphasis added).

In addition, the BEAT can be seen as conceptually similar to a broadly applied thin capitalization rule. In fact, the BEAT replaces the old earnings stripping rule (former IRC section 163(j)).⁸ And thin capitalization rules, even though they do frequently involve denying the interest deduction for interest paid to foreign but not to domestic related parties, are widely used and generally regarded by the OECD as non-discriminatory.⁹

The other relevant provision of Article 24 is paragraph 5, which states that a country may not apply less favorable treatment to an entity owned or controlled by non-residents in comparison with domestically held entities.

Arguably, this paragraph is violated by the BEAT, because a foreign-owned US party will be subject to the BEAT **but a US-owned one would not**. But there are two counter-arguments. First, the BEAT also applies to payments from a US party to a foreign party that is owned by the US party (e.g., a CFC), which shows that the intent was to protect the US corporate tax base, not to discriminate against foreign-owned US parties.

Second, I would argue that the foreign related party and the US related party are not comparable for applying non-discrimination analysis.¹⁰ The reason is that the US knows that a US related party is in fact subject to tax on the relevant deductible items, such as interest, royalties, and in some cases cost of goods sold. But the US does not know that the foreign related party is so taxable by its country of residence, because in many cases these countries will not tax especially foreign source interest or royalties. It should be expected that the enactment of the BEAT would lead multinationals to establish related parties that receive

⁸ Section 163(j) was amended in TCJA to apply a 30% of earnings limit on all business interest, whether paid to domestic or foreign parties.

⁹ See OECD, Committee on Fiscal Affairs, Report on Thin Capitalisation (1986). There was some diversity of opinion about whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. Some consider that paragraph 1 of Article 9 prohibits an adjustment of the profits of a taxpayer beyond arm's length amounts. Others argued that, while paragraph 1 of Article 9 permits the adjustment of profits up to the arm's length amount, it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. Note that in the case of interest, comparables always exist, but IRC section 163(j) applied to deny the interest deduction regardless of whether the interest rate was excessive based on the comparables. Nevertheless, there was no challenge to 163(j) as discriminatory. See Ault, Hugh and Sasseville, Jacques, "Taxation and Non-Discrimination: A Reconsideration" (2010). Boston College Law School Faculty Papers. Paper 286. <http://lawdigitalcommons.bc.edu/lisfp/286>.

¹⁰ Avi-Yonah, Reuven S., FIRPTA, Branch Profit Tax and Earning Stripping: Reflections on Non-Discrimination (March 4, 2013). U of Michigan Public Law Research Paper No. 319. Available at SSRN: <https://ssrn.com/abstract=2228082> or <http://dx.doi.org/10.2139/ssrn.2228082>.

deductible payments from US parties precisely in those jurisdictions that exempt such payments because otherwise they would risk double taxation since a credit would normally not be immediately available.

As I have argued elsewhere, the guiding spirit behind the international provisions of the TCJA is the single tax principle, and under the single tax principle, it is perfectly appropriate for the US to deny a deduction for items that it has no reasons to believe will be taxed on a residence basis.¹¹ No violation of article 24(5) should arise under those circumstances.

4. Conclusion: Is a Treaty Override Needed?

It could be argued that the above analysis is irrelevant because the US is able as a matter of both constitutional and statutory law to override treaties by domestic legislation, and therefore even if the TCJA were deemed to contradict article 24, it would not have any legal implications because the TCJA would be an override.¹²

However, US courts have generally been reluctant to find overrides unless Congress explicitly stated an override was intended, which it did not for the BEAT. Moreover, Congress has in the past been eager to seem compliant with article 24 even when it could have overridden it. This is clear from the history of IRC section 163(j), which was applied to “tax exempt related parties” to avoid the appearance of discrimination against foreign related parties even though no US tax exempt ever owns the requisite percentage (over 50%) to be related to a US for profit enterprise.

Thus, the above analysis remains relevant inasmuch as it shows that **the BEAT does not violate US tax treaties**. This should make our treaty partners and OECD think twice before they engage in retaliatory actions. After all, the BEAT is perfectly consistent with some of their own recent actions to protect the corporate tax base, such as the UK and Australian diverted profit tax and the proposed EU digital equalization taxes.¹³

¹¹ Avi-Yonah, Reuven S., *The Triumph of BEPS: US Tax Reform and the Single Tax Principle* (December 2, 2017). U of Michigan Public Law Research Paper No. 579; U of Michigan Law & Econ Research Paper No. 17-021. Available at SSRN: <https://ssrn.com/abstract=3081523> or <http://dx.doi.org/10.2139/ssrn.3081523>.

¹² Avi-Yonah, *Tax Treaty Override: A Qualified Defense of US Practice*, in G. Maisto (ed.), *Tax Treaties and Domestic Law 65*(2006) (also on ssrn).

¹³ Avi-Yonah, *Three Steps Forward, One Step Back? Reflections on “Google Taxes” and the Destination-Based Corporate Tax*, 2 *Nordic Tax J.* 1 (2016) (also on ssrn).

The correct OECD response to the BEAT would be to encourage other OECD members to adopt similar measures and apply them to US multinationals.¹⁴ This is not a “tax war”: It is a long-overdue response to the BEPS by US and other multinationals and a correct application of the single tax principle to prevent double non-taxation.

¹⁴ Avi-Yonah, Reuven S. and Mazzoni, Gianluca, Tit for Tat: How Will Other Countries React to the Tax Cuts and Jobs Act? (December 21, 2017). U of Michigan Law & Econ Research Paper No. 17-022; U of Michigan Public Law Research Paper No. 581. Available at SSRN: <https://ssrn.com/abstract=3089052>.