

A CRITIQUE OF BEAT CRITIQUES

By Omri Marian*

I. INTRODUCTION

The Tax Cuts and Jobs Act¹ (“TCJA”) dramatically changed how the United States taxes multinational corporations (“MNCs”). Most notably, the TCJA introduced a “participation exemptions system”, under which earnings of foreign subsidiaries of MNCs are exempt from U.S. tax² (under previous law, earnings of foreign subsidiaries were taxed if repatriated to the United States). A participation exemption system exacerbates the incentive of U.S. MNCs to shift income from the U.S. to foreign subsidiaries organized in low-tax countries.

Aware of this fresh incentive to shift income, Congress introduced myriad new anti income-shifting provisions as part of the TCJA. Among others, such provisions deny deductions on certain deductible “hybrid” payments,³ impose a new tax on “Global Intangible Low Taxed Income” (GILTI),⁴ and create a Base Erosion Anti-Abuse Tax (the “BEAT”).⁵ The BEAT is a minimum tax that operates by denying certain tax benefits associated with related party transactions.

All of these new base-broadening rules have been the subject of recent commentary. None, however, has been subject to more complaints than the BEAT. Among others, it has been argued that the BEAT violates U.S. treaty obligations,⁶ violates U.S. WTO obligations,⁷ creates double taxation resulting in very high effective tax rates in some instances (as much as 29.5% instead of the headline corporate tax rate of 21%),⁸ is inefficient and unfair due to “cliff effects”,⁹ and that it simply does not make colloquial sense.¹⁰

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¹ An Act to Provide For Reconciliation Pursuant To Titles II And V Of The Concurrent Resolution On The Budget For Fiscal Year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

² Internal Revenue Code (I.R.C.) §245A allows a deduction for the full amount of dividends received by MNCs from certain foreign subsidiaries, and effectively exempts the foreign earnings of such subsidiaries from taxation.

³ I.R.C. §267A.

⁴ I.R.C. §951A.

⁵ I.R.C. §59A.

⁶ H. David Rosenbloom and Fadi Shaheen, *The BEAT and the Treaties* (Aug. 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3229532 [<https://perma.cc/565Z-TSSA>] (arguing the BEAT overrides tax treaties); *but cf.*, Reuven S. Avi Yonah, *Beat It: Tax Reform and Tax Treaties* (Jan. 1, 2018), https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1260&context=law_econ_current [<https://perma.cc/VWT6-6ZNS>] (arguing that the BEAT does not violate tax treaties); Bret Wells, *Get with the BEAT*, 158 TAX NOTES 1023 (Feb. 19, 2018) (same); Reuven Avi-Yonah & Bret Wells, *The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen* (Aug. 17, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232974 [<https://perma.cc/5R9A-ZZEE>] (same).

⁷ Rebecca Kysar, *Will Tax Treaties and WTO Rules ‘Beat’ the BEAT?*, 10 COLUM. J. TAX L. TAX MATTERS (forthcoming Nov. 2018) (discussing how the BEAT potentially violates U.S. WTO obligations).

⁸ Martin A. Sullivan, *Economic Analysis: 10 Reasons Congress Should Revisit the BEAT*, 159 TAX NOTES 1701 (June 18, 2018) (calculating effective tax rate resulting from BEAT interactions with other taxes on cross-border income).

⁹ *Id.* (discusses the cliff effect resulting from the 3 percent threshold requirement).

¹⁰ Lee A. Sheppard, *News Analysis: Proposed Regs Coming on TCJA International Rules*, 158 TAX NOTES 991 (Feb. 19, 2018) (explaining that a literal reading of I.R.C. §59A suggests that affiliated corporations are treated as a single entity, and under such reading inter-company payments—to which BEAT applies—can exist).

While there is much to improve about the BEAT, a significant part of the criticism against the new law is unwarranted. Many of the critiques make use of unlikely hypothetical business structures to demonstrate supposed failures in the operation of the new law. I shall argue, however, that many of the hypotheticals used are either irrelevant (as they assume business structures that no taxpayers would reasonably use) or extremely rare. In other instances the examples used are more realistic, but the complaints are made against the successful operation of the law as intended.

While the use of hypotheticals is many times “pedagogically helpful, a concern is the extent to which examples ... may not reflect general (or for that matter actual) experience.”¹¹ When unhelpful hypotheticals are used, the critique should be muted. If anything, these types of complaints from taxpayers demonstrate BEAT is a successful anti-shifting mechanism with real teeth.¹²

This essay will continue as follows: Part II briefly explains what I mean by “unhelpful hypotheticals,” and demonstrates how they are used by taxpayers. In Part III, I briefly outline the operation of the BEAT, and explore two hypotheticals employed by taxpayers to argue against the BEAT.

II. THE ILLOGICAL TAX HYPOTHETICAL

In tax law, hypotheticals are an essential instrument to explain and demonstrate the operations of complex law provisions. Academics use them in scholarly papers, taxpayers use them to comment on proposed regulations, and even regulations themselves use hypothetical fact patterns to demonstrate the operation of the law.¹³

However, on occasion, hypotheticals are used in a way that does not make very much sense, only to support one’s point of view. In such instance a speaker uses a hypothetical to demonstrate how a tax provision can bring about an illogical result, but the hypothetical itself is illogical.

This method of critique is not new, and is sometimes even successful at convincing courts to adopt a particular stance. Consider, for example, *SDI v. Commissioner*,¹⁴ in which a Bermuda company owned intellectual property, which was used by a U.S. affiliate. Royalties paid by the U.S. affiliate to the Bermuda entity would have been subject to withholding at a 30% gross rate.¹⁵ In order to avoid this result, the SDI groups organized a Netherlands entity, which licensed the IP from Bermuda, and then relicensed the IP to the U.S. in a back-to-back arrangement. The royalties

¹¹ Patrick Driessen, *Getting Past the Standard BEAT Story*, 160 Tax Notes 1269, 1269 (Aug. 27, 2018).

¹² Reuven S. Avi-Yoanh, *The International Provisions of the TCJA: Six Results of Six Months* (U. Mich. Law Sch., Public Law and Legal Theory Research Paper No. 621, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3242008. [<https://perma.cc/3Q45-QTHT>] (“BEAT is a success, at least if one listens to the endless complaints about it from practitioners, which indicates it has real teeth.”).

¹³ For a discussion on the use of hypothetical examples in Treasury Regulations, see Yariv Brauner, *Why Examples? Towards More Behaviorally-Intelligent Regulation*, 37 VA. TAX REV. 243 (2018).

¹⁴ *SDI Neth. B.V. v. Comm’r*, 107 T.C. 161 (1996).

¹⁵ I.R.C. §881.

from the U.S. were paid to the Netherlands entity, which immediately turned and paid royalties to Bermuda.

Under the tax treaty between the U.S. and the Netherlands at the time, royalties paid to a Dutch company were exempt from withholding. Under Netherlands law, royalties paid to Bermuda were also exempt. Thus, the U.S. affiliate was able to deduct the cost of royalties against U.S. income, without the royalties being taxed anywhere else.

The Service argued that the royalties paid by the Netherlands entity to Bermuda retained their character as U.S.-source royalties, and as such should be subject to withholding.¹⁶ The court disagreed. Among the arguments made by the taxpayer and accepted by the court, was that accepting the IRS position would create a “cascading royalties” problem, “whereby multiple withholding taxes could be paid on the same royalty payment as it is transferred up a chain of licensors.”¹⁷

Hypothetically, this argument is doctrinally correct. However, this fact is irrelevant. Had royalties been subject to cascading taxation, it would be irrational for taxpayers to create back-to-back royalties licensing schemes. In the SDI case, the taxpayer would simply pay the royalties directly to Bermuda, and pay one level of tax (or simply have the IP held by the U.S. affiliate). There would be no reason, other than an attempt at self-inflicted pain, to create an intermediary entity.

III. UNHELPFUL HYPOTHETICALS AND BEAT CRITIQUE

Similar use of unhelpful hypotheticals can be identified in the context of some common critiques levied against the BEAT. I first briefly explain the structure of the BEAT, and then discuss two common critiques I find problematic.

A. A Short BEAT Primer

Section 59A operates as a minimum tax, which kicks in when U.S. taxable income is excessively reduced through related party transactions. Conceptually, a 10% minimum tax is imposed on an alternative tax base, which is calculated by ignoring certain related party transactions.

More specifically, if a taxpayer is an “applicable taxpayer”,¹⁸ a new tax base (called “modified taxable income”)¹⁹ is calculated by ignoring any “base erosion tax benefit”.²⁰ A base erosion tax

¹⁶ SDI v. Comm’r, *supra* note 14, at 171 (“Respondent focuses her argument solely on the proposition that, since the royalties paid by SDI USA to petitioner were U.S. source income, they retained that character as part of the royalties paid by petitioner to SDI Bermuda and, *as a matter of law*, constitute income ‘received from sources within the United States by’ SDI Bermuda under section 881(a).”).

¹⁷ *Id.* at 176.

¹⁸ I.R.C. §59A(e).

¹⁹ I.R.C. §59A(c).

²⁰ *Id.*

benefit is generally any reduction in U.S. tax base, which is a result of transactions between related parties²¹ (such as a deductible payment to a related party that is not a U.S. resident). The BEAT is then calculated by comparing 10% of the modified taxable income to the normal tax liability calculated without the limitations of Section 59A. If the 10% amount is higher than the regular tax liability, the difference is added to the tax liability of the taxpayer. That difference is the BEAT. The effective result is a minimum tax of 10% on a broadened tax base that ignores related-party tax reducing schemes.

Applicable taxpayers are generally corporations that meet two requirements: (1) They have an average of \$500,000,000 in annual gross receipts (measured on an affiliated group basis) measured during a 3-taxable-year period ending with the preceding taxable year, and (2) at least 3% of their total deductions are base erosion payments of the type that creates base erosion tax benefits.²²

B. The BEAT/GILTI Double Tax Hypothetical

One frequent objection to the BEAT is that it generates double taxation on deductible payments to certain related foreign parties. Some additional background is helpful here.

Under the law in effect before the TCJA, U.S. MNCs were subject to taxation on their worldwide income. Income earned by controlled foreign subsidiaries, however, was not subject to tax in the U.S. until repatriated (for example, as a dividend to the U.S. parent). This created an incentive for U.S. MNCs to shift income into subsidiaries in low-tax jurisdictions, and have profits accumulate there. The incentive is exacerbated by the TCJA, as it exempts dividends from foreign subsidiaries from taxation in the United States. In order to counter these incentives to shift income, U.S. law contains an anti-abuse rule known as “Subpart F”.²³

Under subpart F, certain types of passive income (“Subpart F income”) earned by “controlled foreign corporations” (“CFC”) are deemed repatriated to the United States, even if no actual distribution from the CFC to the U.S. shareholder occurred. As such, Subpart F income earned by a CFC is immediately taxable to the U.S. shareholders of the CFC.

The TCJA adds a new category of Subpart F income, known as “Global Intangible Low-Taxed Income” (“GILTI”).²⁴ Under the GILTI, income attributable to intellectual property, earned by foreign subsidiaries, is subject to immediate taxation to U.S. shareholder at effective rates between 10.5% and 13.125%.²⁵ GILTI income is any profit above 10% threshold of assumed-return from CFC’s tangible assets.

²¹ I.R.C. §59A(g).

²² I.R.C. §59A(e).

²³ “Subpart F” is the commonly used shorthand for Chapter 1, Subchapter N, Part II, Subpart F of the I.R.C. It is codified in I.R.C. §§951-65.

²⁴ See I.R.C. §951A.

²⁵ The GILTI headline rate is 10.5%. However, if the same income is subject to tax in a foreign jurisdiction, a taxpayer would normally be granted a credit for foreign tax paid. Under the GILTI rules, however, only 80% of the foreign tax paid may be credited, resulting in an effective tax rate as high as 13.125%. For a closer discussion of the GILTI rules,

The introduction of GILTI and BEAT has the potential to create an excessive tax burden according to a new, frequently-made argument.²⁶ Consider a deductible payment made by a U.S. MNC to its CFC. Under the BEAT, the benefit of the deduction is eliminated, making the income taxable in the United States. Under the GILTI (or subpart F), the income earned by the CFC is potentially GILTI or other subpart F income, and as such would be taxable (again) to the U.S. MNC. The result is that the same stream of income is taxed twice in the United States. The resulting effective tax rate can be as high as 29.5% instead of the corporate headline rate of 21%. This is a correct doctrinal analysis of the interaction of BEAT and GILTI, and the result seems nonsensical. It is therefore not a surprise that multiple practitioners advanced such criticism.

There is one problem with this frequently-used example, though. It does not represent a frequent conceivable realistic occurrence. A U.S. MNC making a deductible payment to a CFC under the new law would simply be engaged in tax malpractice. And no U.S. MNCs should rationally choose to do that.

Presumably, even under the old law there was generally little incentive for a U.S. MNC to make a deductible transfer to its CFC. Even if the payment was deductible, the income to the CFC should have resulted in Subpart F income, immediately taxable to the U.S. MNC. The result was a wash.

However, subpart F contains many exceptions that made it possible for U.S. MNCs to get away with such payments and not include them as subpart F income.²⁷ US MNCs were able to make deductible payments to related parties in tax havens, stripping the U.S. tax base without ever having the income picked up in the tax base of any other entity. The BEAT prevents that by effectively denying the deduction.

If that is the case now, why would any U.S. MNC to which BEAT is applicable make a payment subject to BEAT to a CFC? If there is a need to transfer funds to a controlled subsidiary, the MNC can simply make an equity contribution (which, generally, has no tax consequences), or have the subsidiary borrow directly from a third party (the parent could guarantee the loan, if necessary). Why would a corporate executive structure a transfer of funds in a way that is known to result in double taxation, given that there are multiple single-taxation alternatives?

This is similar to the logic used by the SDI court in the context of cascading royalties. The royalties were structured as back-to-back payments through an intermediary specifically to avoid taxation. Had the result of such a structure been double-taxation, no royalty payment would ever be structured as such. The bottom line is that the double-tax arguments against the BEAT are

see, e.g., Martin A. Sullivan, *Economic Analysis: More GILTI Than You Thought*, 89 TAX NOTES INT'L 587 (Feb. 12, 2018).

²⁶ See, e.g., NEW YORK STATE BAR ASSOCIATION, REPORT NO. 1397 ON BASE EROSION AND ANTI-ABUSE TAX 18-19 (July 16, 2018), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1397_Report.html [<https://perma.cc/9BVN-NC6N>] (describing hypothetical double taxation when both BEAT and Subpart F apply to the same payment); James T. Tobin, *Don't Like Da BEAT*, 47 TAX MGMT. INT'L J. 266 (Apr. 13, 2018) (same).

²⁷ For a discussion of such exemptions, see J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L. J. 79 (2009).

nonsensical, because no taxpayer will ever willingly make such payments. The real complaint here is against the fact that the BEAT actually prevents tax avoidance, by taxing (once) income that previously escaped taxation.

To be sure, there may be some existing corporate structures that may actually result in double taxation and may have to be restructured (though I suspect such cases are relatively rare, and in any case are themselves tax driven). This may be a good reason to argue for some transitional relief rule that would allow MNCs to restructure successfully. However, the correct way to analyze the incentives created by the BEAT is under a steady state world. Meaning, envisioning how the world would look like after the BEAT had taken effect and changed corporate behavior. The existence of tax-avoidance corporate structures (used to avoid tax under the old law) cannot in and of itself be used as an argument against the BEAT. The BEAT responds specifically to tax avoidance. Arguing that existing structures would now be subject to “double tax” misses the point: the BEAT exact intent is to undo these structures..

C. The Cliff Hypothetical

Another frequently made argument against the BEAT is that it contains cliff effects. “Cliff effects ... trigger a sudden increase of federal tax liability when some attribute of a taxpayer...exceeds a particular threshold value.”²⁸ Cliff effects are viewed negatively, as they create a line drawing problem. Taxpayers close to the threshold trigger may behave inefficiently to avoid triggering the cliff.²⁹ Cliff are also sometime seen as unfair, because two very similarly situated taxpayers that just happen to be on different sides of the trigger face vastly different tax burdens.³⁰

In the context of the BEAT, the cliffs are triggered by the definition of “applicable taxpayers”. As noted, BEAT is only triggered with respect to taxpayers with average annual sales of \$500,000,000, and only if at least 3% of all their deductible payments are base erosion payments.

This leads critics to argue that taxpayers who are just below either of the two triggers may alter their behavior to avoid the BEAT, and that if the BEAT is triggered the consequences can be colossal, since the entire tax is triggered at once.³¹

If the taxpayer is close to the sales-level trigger, it does not always make sense for the taxpayer to try to sell less, just to avoid the tax. As long as after-tax sales are profitable, the taxpayer would prefer to sell more even if the BEAT is triggered. Arguing that taxpayers would try to avoid this threshold is a “tail wagging the dog” argument. Business considerations dictate tax outcomes, not the other way around.

²⁸ Manoj Viswanathan, *The Hidden Costs of Cliff Effects in the Internal Revenue Code*, 164 U. PA. L. REV. 931, 931 (2016).

²⁹ *Id.* at 933 (“The ‘cliff effects’ attached to these tax provisions can drastically affect taxpayer behavior and undermine what these provisions are intended to accomplish.”).

³⁰ *Id.* at 955-57 (discussing equity concerns of cliffs).

³¹ Martin A. Sullivan, *Economic Analysis: Statutory Interpretation of the BEAT Services Exception Is Bad News*, 160 TAX NOTES 1203 (Aug. 27, 2018) (describing taxpayers’ complaints regarding BEAT cliff effects).

If the after-tax sales are not profitable as a result of triggering the BEAT sales trigger, it may mean that the taxpayers' profits pre-BEAT were attributable to tax avoidance, and not to economic substance. If this is indeed the case, these are exactly the type of taxpayers the BEAT is after, and exactly the type of behaviors the BEAT is aimed to prevent.

If a taxpayer is close to the 3% base erosion payment threshold, then the cliff concern is substantially reduced. Once the threshold is triggered, the taxpayer loses 3% of its deductions, and from that point the BEAT *gradually* increases the more related party payment are made. So again, if taxpayers want to avoid this threshold, they should be engaged in less tax-motivated related-party transactions.

If the cliff effect is still worrisome, the solution is to simply eliminate any threshold and apply the BEAT to all taxpayers from the first dollar of earnings, denying the benefits of all related party tax-motivated payments. In such case, there will be no cliff effects whatsoever, and taxpayers will pay more BEAT the more base-erosion payments they have. I doubt, however, that this is a solution the complainants are aiming for.

IV. CONCLUSION

The BEAT is a new, original anti tax avoidance mechanism. As many commentators have noted, the law itself requires multiple clarifications, and is sometimes hard to understand. It is a complex provision. But many of the arguments against the BEAT's intended operation seem to use unhelpful hypotheticals to advance a particular anti-BEAT narrative.