Universitè du Luxembourg

US Tax Reform and its Impact on the EU

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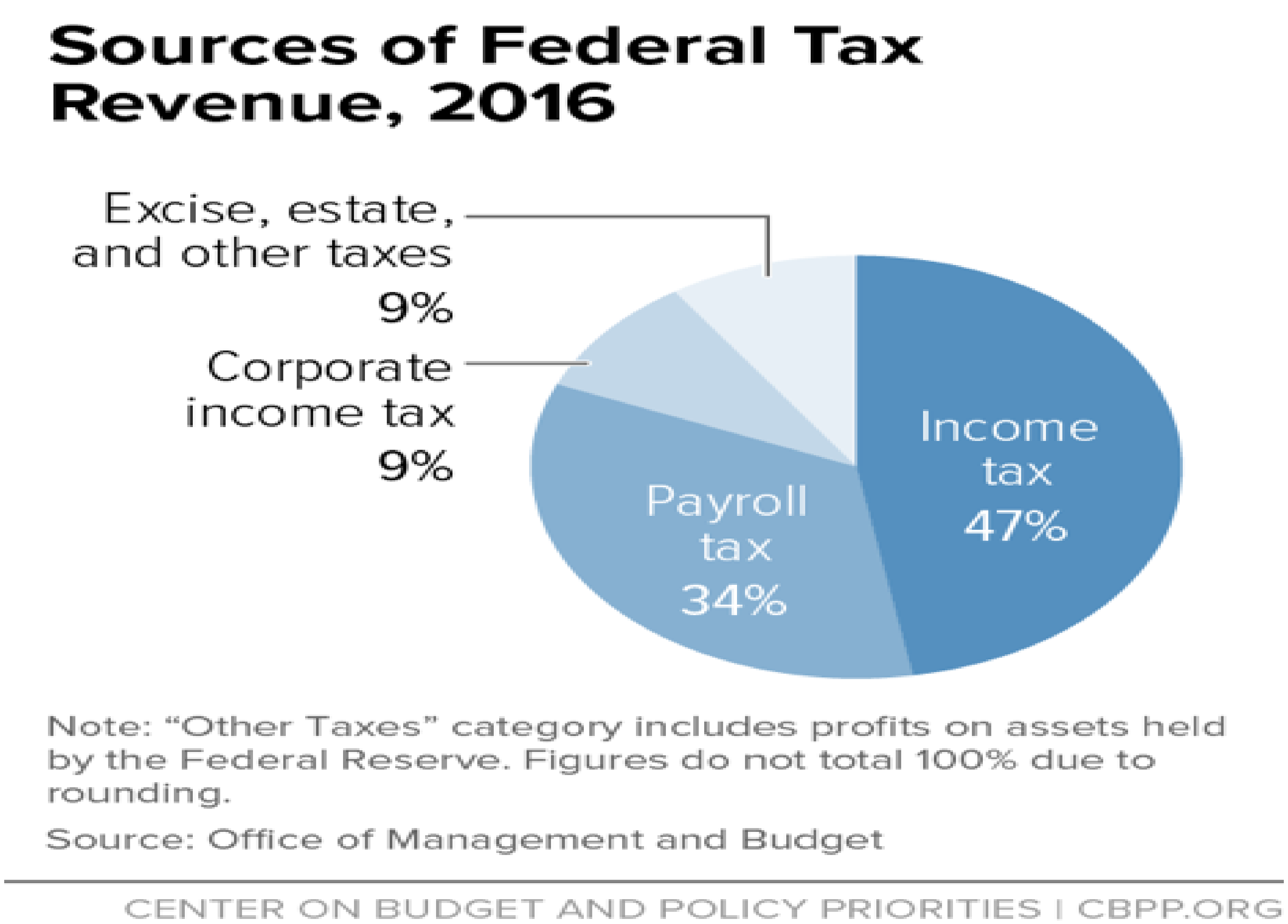
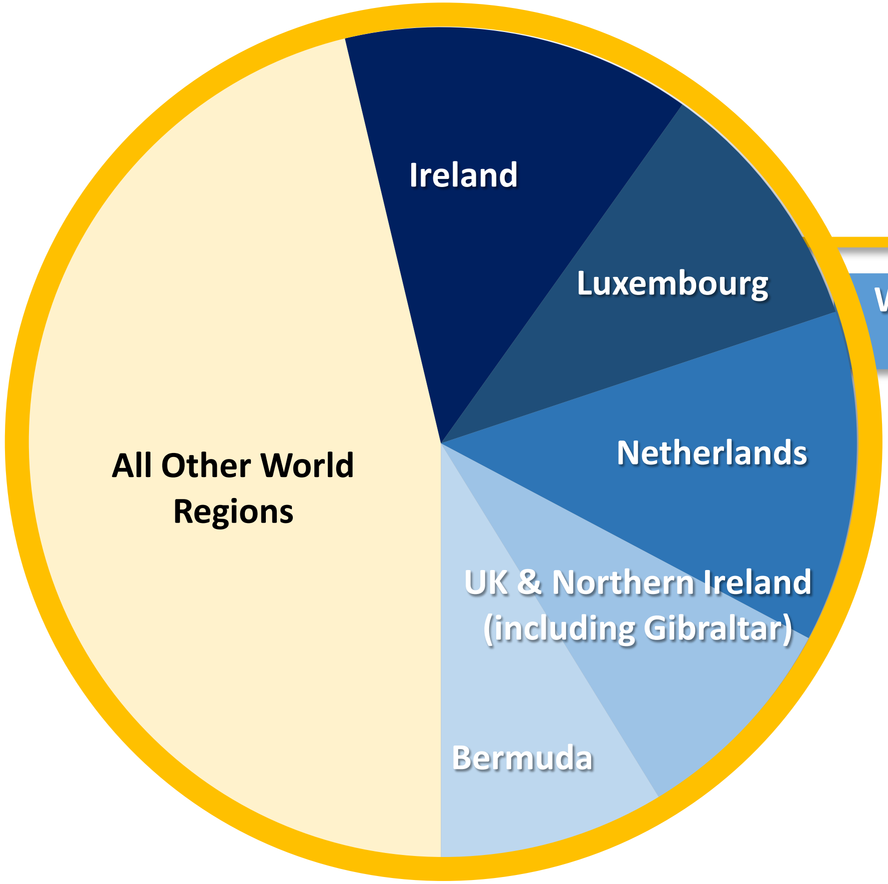
Topics

- Background to US tax reform: Data and Political Rhetoric
- Contours of the U.S. international reforms
- Initial responses and evaluations

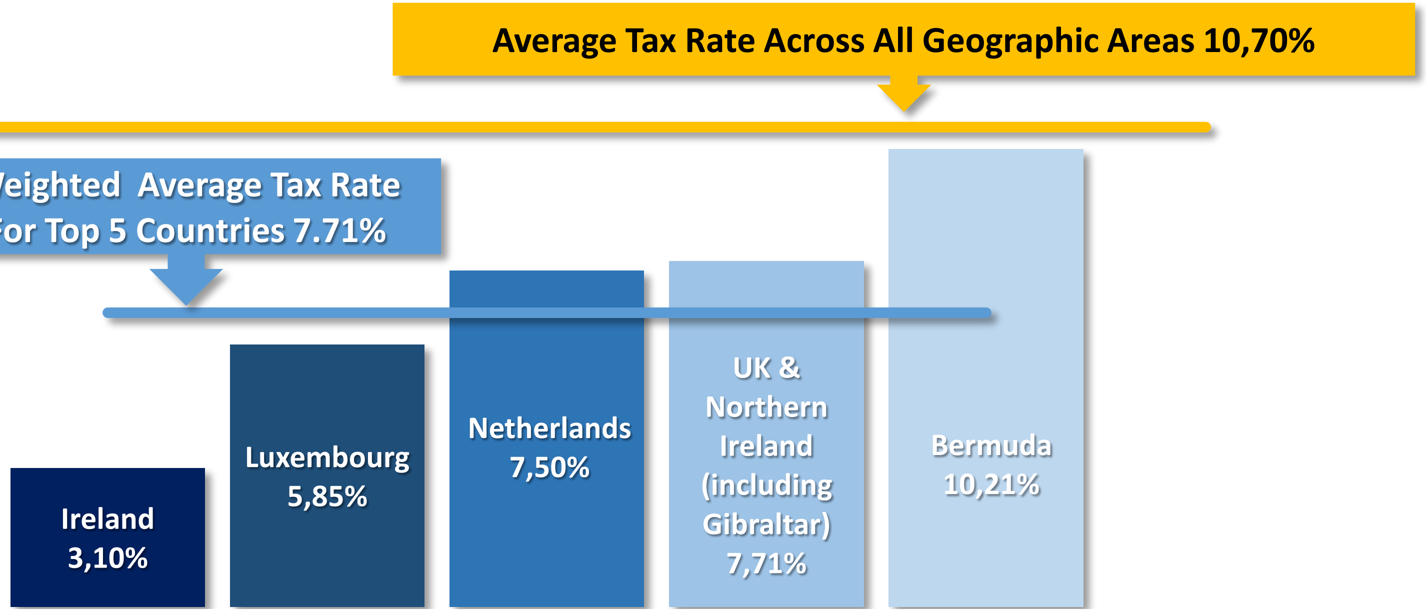
Background to US Tax Reform – US (Continued) Reliance on Income Taxation



Background to US Tax Reform – Income Shifting
2014 Earnings and Profits Before Tax of CFCs by Country – Country Shares



Percentage of Earnings and Profits by Country

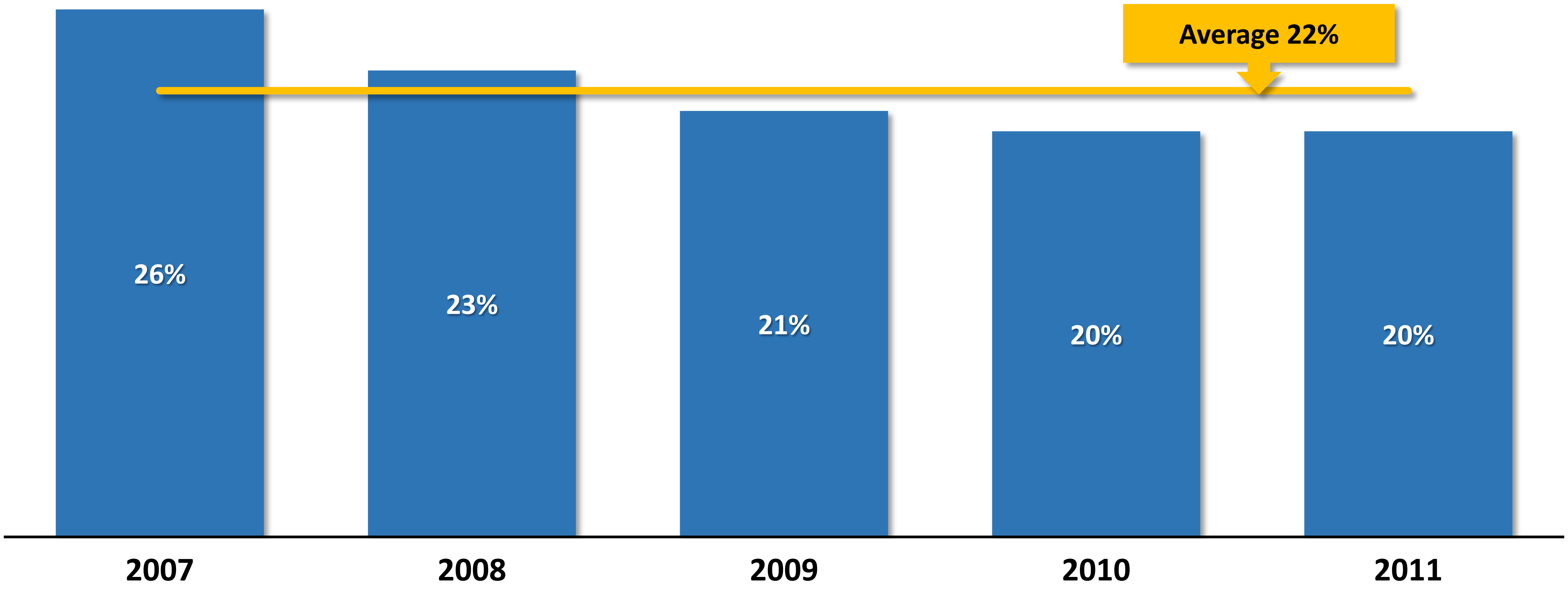


Effective Average Tax Rates for Top 5 Countries –
Includes Effects of Disregarded Business Entities Owned By CFC

Source: IRS, Statistics of Income Division, September 2017, U.S. Corporations and CFCs, Table 2 and author's calculations

Background to US Tax Reform – Average Effective “Actual” Federal Corporate Tax Rate (ATR)

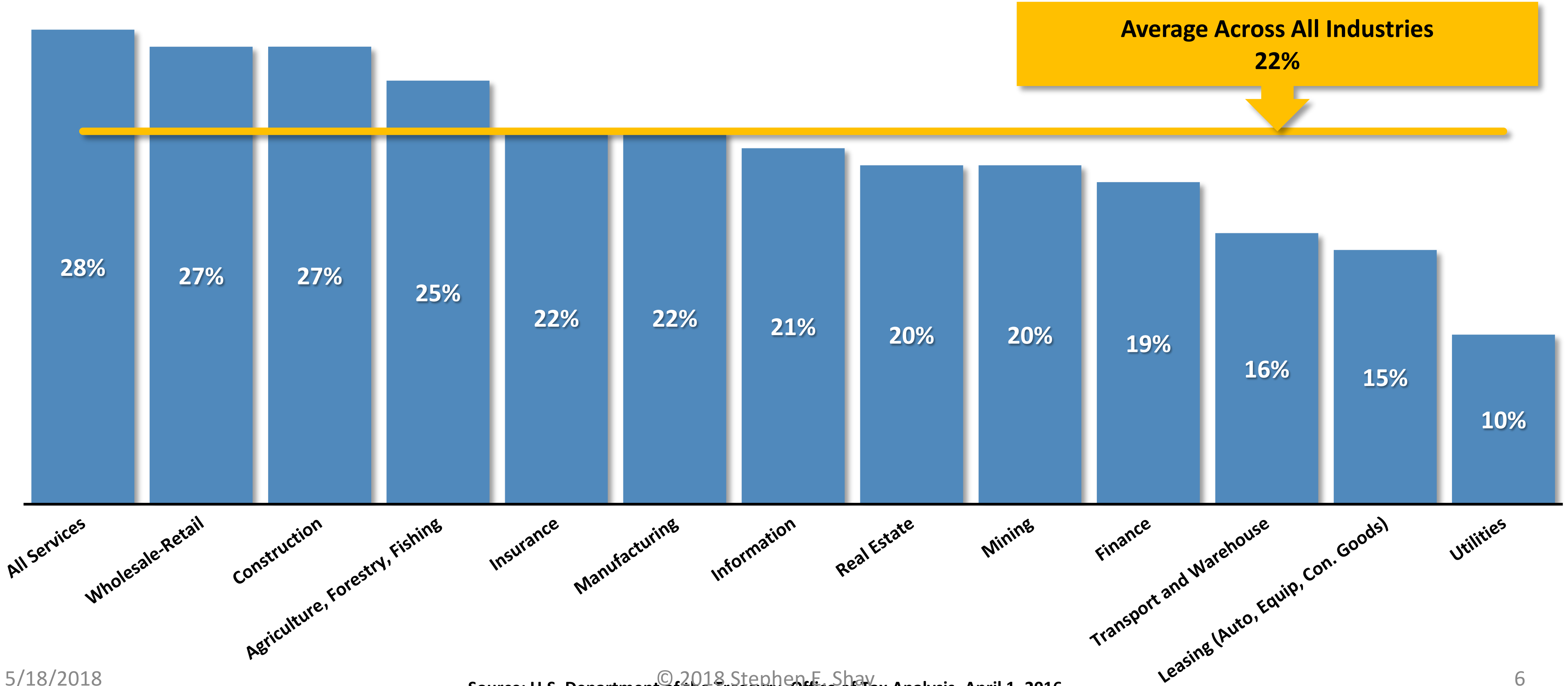
US Corporations with Positive Income and > $10M Assets – By Year 2007-2011



Source: U.S. Department of the Treasury, Office of Tax Analysis, April 1, 2016

Background to US Tax Reform – Average Effective "Actual" Federal Corporate Tax Rate

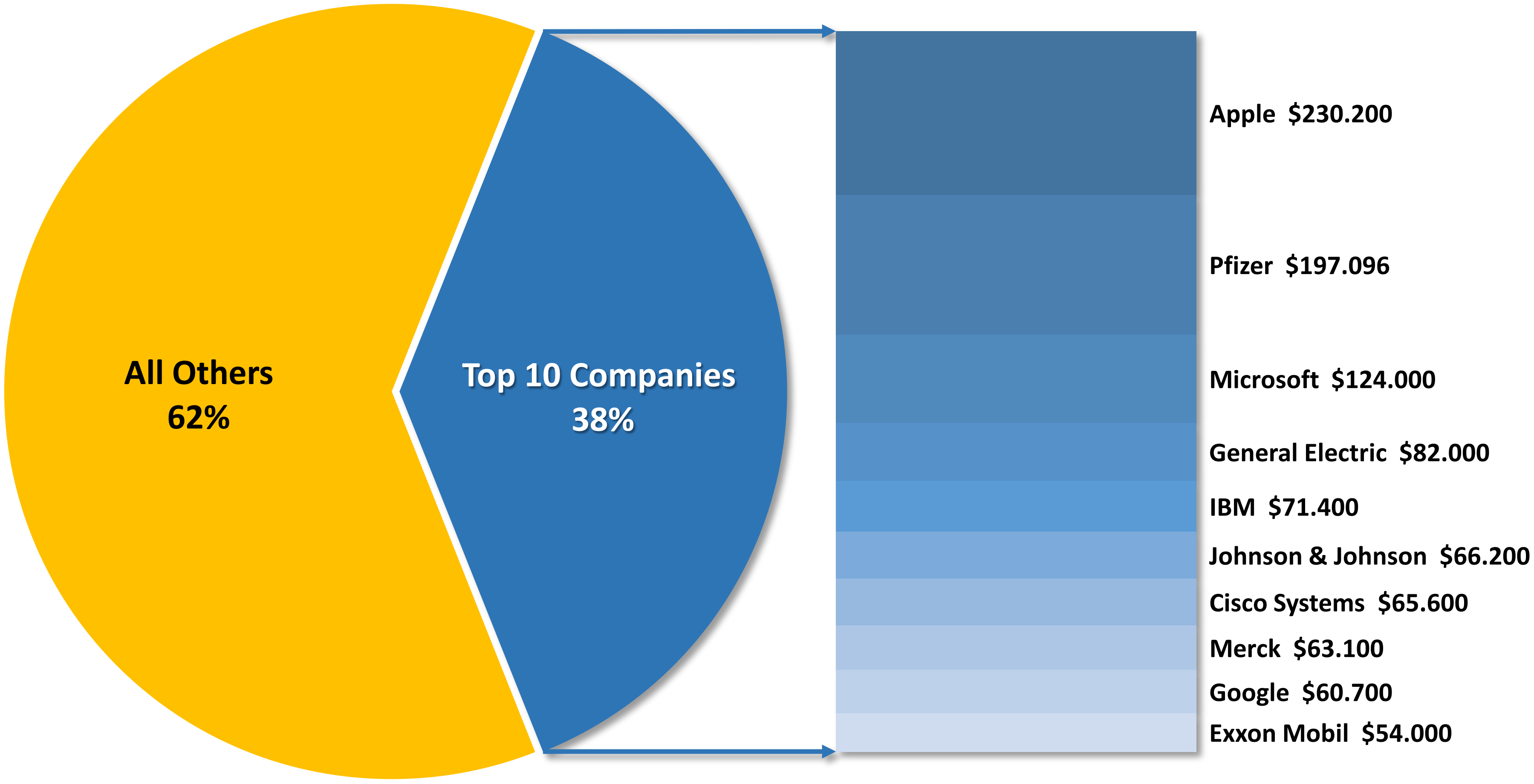
US Corporations with Positive Income and > $10M Assets – By Industry Average 2007-2011



Source: U.S. Department of the Treasury, Office of Tax Analysis, April 1, 2016

Offshore Indefinitely Reinvested Earnings of U.S. Fortune 500 Companies (2016)

38% held by 10 Companies (US $ Millions)



Source:
ITEP, "Fortune 500 Companies Hold a Record $2.6 Trillion Offshore“ (March 28, 2017)

Background to US Tax Reform – Rhetoric

Congressional Republicans (mostly) favor:

- Globalization, trade and investment
- Make U.S. multinationals more “competitive” –
  - Lower tax rates, exempt foreign business profits
  - Tax treaties should reduce source country taxation
    - Lower or no positive withholding rates
    - High threshold for permanent establishment

Congressional Democrats

- Concern about the dangers of globalization; Tax arbitrage; Tax evasion
- Update treaties to expand information exchange and update anti-treaty-shopping provisions
- 2016 U.S. Model focused on risk of double *non*-taxation

Contours of the U.S. international reforms

1. Reduction of corporate tax rate from 35% to 21%
   - Effects of this rate reduction and foreign government responses will take time to reach equilibrium and for tax planners to absorb
2. Partial dividend exemption (for 10% return on tangible capital) and reduced rate tax on the rest (misnamed GILTI income) (effective 10.5% pre-FTC, but haircuts on FTCs) – hybrid worldwide and exemption system for foreign
3. Reduced rate (effective 13.125%) subsidy for income from exports of sales and services (FDII) in excess of 10% return on tangible capital
4. BEAT alternative tax on large corporations' deductible payments to foreign related persons and non-R&D credits
   - Part anti-base erosion and part corporate minimum tax

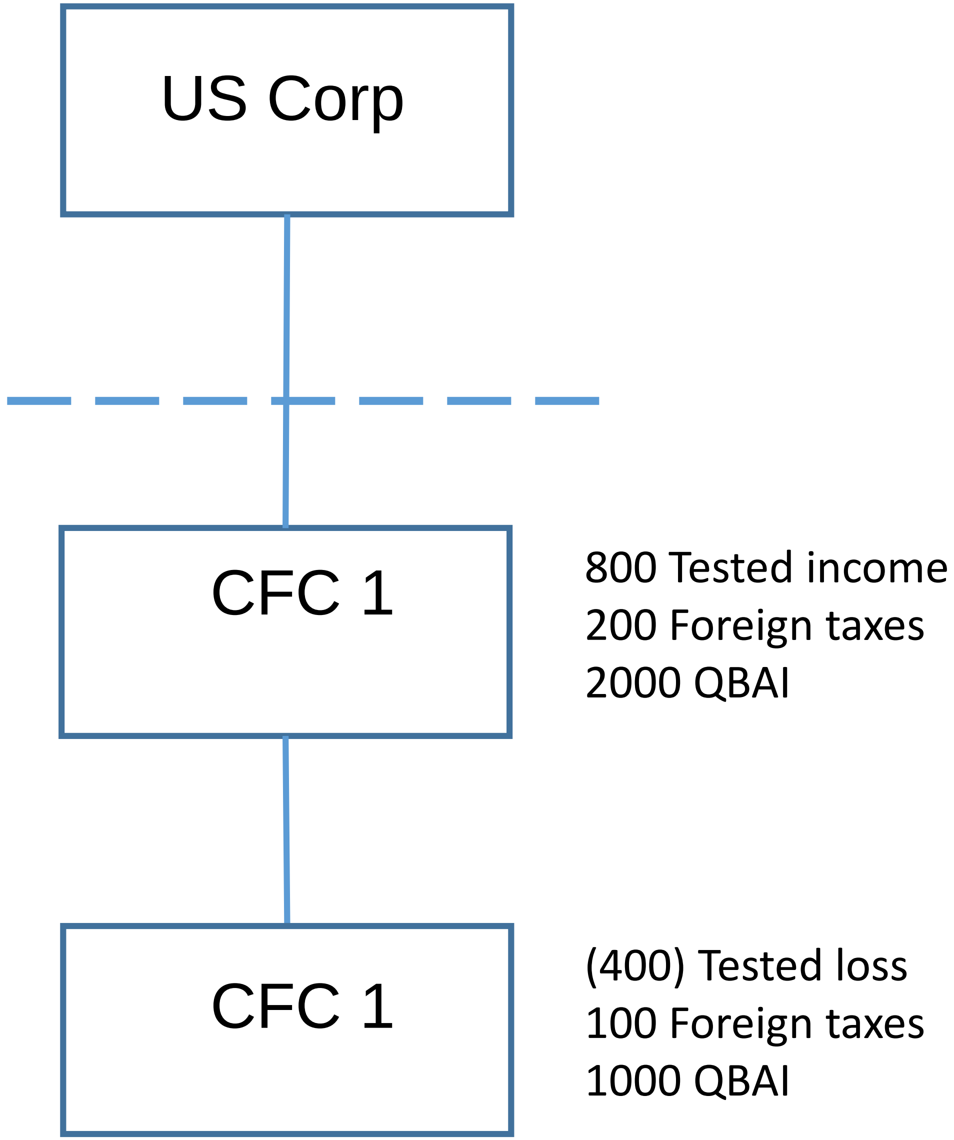
100% Dividends Received Deduction for Non-Subpart F and Non-"GILTI" CFC Income

- Partial dividend exemption through a 100% dividends received deduction (i.e., comparable to European-style participation exemption)
- Generally available for the foreign-source portion of dividend received by corporate U.S. shareholder (10% vote or value) from a foreign corporation on shares held one year.
- "Partial" dividend exemption because not applicable to:
  - Distributions of earnings previously taxed as subpart F or GILTI (exempt under section 959 as PTI) , hybrid dividends or dividends from PFICs.
  - Generally applies to earnings equal to deemed tangible income return.

GILTI – Income

- GILTI is determined at the United States shareholder (USS) level based on aggregate of USS's positive pro rata share of each CFC's "tested income" or "tested loss" over USS's pro rata share of Net Deemed Tangible Income Return.
  - Net CFC Tested Income (aggregate basis) - Net Deemed Tangible Income Return (NDTIR) (aggregate basis) = GILTI
  - NDTIR = Qualified Business Asset Investment ("QBAI") X 10% less interest expense.
  - Tested Income is CFC gross income less: US ECI, Subpart F income, high taxed income (elective), related person dividends, foreign oil and gas extraction income. Then subtract deductions. If negative, = tested loss.
- GILTI generally is net positive CFC foreign income not Subpart F or NDTIR. Eligible for 50% deduction so effective rate is 10.5%.
- Only 80% FTCs allowed and FTC limitation also reduced by allocable USS expenses; separate limit, no carryovers.

GILTI – Example*



	CFC 1	CFC 2	US Corp
Tested income	800	-400	
Foreign taxes	200	100	
QBAI	2000	1000	
Deemed TIR	200	0	
Net CFC Tested Income			400
Deemed TIR			200
GILTI			200
Allocation of GILTI to CFCs	200	0	
Deemed paid taxes	50	0	
80% Haircut	40		40

GILTI (Exclude as High taxed?)	200
Section 250 Deduction	-100
Taxable Income	100
Tentative US tax	21
Foreign Tax Credit	21
Excess FTC	19

* Thanks to DC Bar Panel Presentation (Jan. 2018)

Foreign Derived Intangible Income (FDII)

- Foreign derived intangible income (FDII) is the portion of “deemed intangible income” of a domestic corporation determined by ratio of foreign-derived deduction eligible income – generally, exports sales of property (sold to a foreign person for foreign use), foreign services and foreign royalties – to “deduction eligible income.”
- “Deemed intangible income” = Deduction Eligible Income - (DTIR or 10% × QBAI)
  - DTIR comes out before reaching deemed intangible income
  - DTIR it is apportioned pro rata between FDII and the rest of deemed intangible income.
- The Section 250 FDII deduction is 37.5% (21.875% after 2025), resulting in a *effective* tax rate of 13.125% through 2025 and 16.41% thereafter

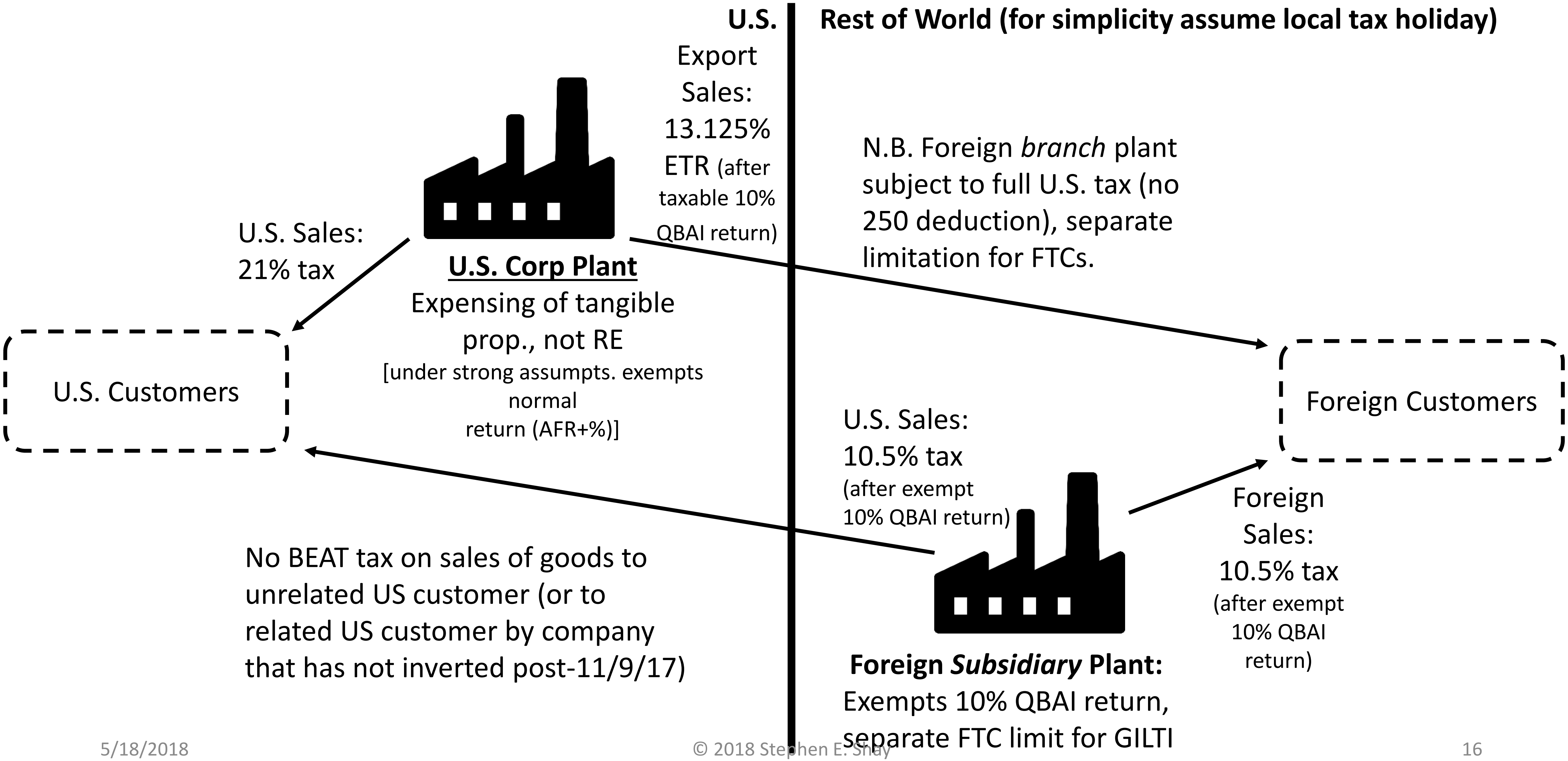
BEAT – Anti-Base Erosion and a Minimum Tax

- The BEAT is an alternative minimum tax that applies to large domestic corporation (group US-related sales > $500M) when the tax under BEAT exceeds the regular tax. The domestic corporation
  - BEAT = 10% x Modified taxable income > Regular tax liability – credits in excess of R&D credits and 80% applicable credits (LIHC, renew. elect. prod., energy ITC)
  - In other words, credits other than R&D and 80% of applicable credits reduce the hurdle for the BEAT to be positive thereby losing benefit of those credits, including foreign tax credits.
- Modified taxable income = Taxable income + base erosion tax benefits + base erosion % of NOL deduction. Base erosion tax benefits must > 3% of all deductions.
- Base erosion payments (to foreign related persons) include: Interest (interest disallowed under 163(j) allocated to unrelated payments first), payments for acquisition of property that gives rise to a depreciation and amortization deduction, payments for services, royalties, premiums/other consideration for reinsurance, COGS (only to newly inverted entities).

Contours of the U.S. international reforms

- An *ex post* theoretical rationale for this configuration of policies:
  - Ten percent return to tangible capital is a “normal” return; and the excess is “mobile” rents (suspend criticism that 10% is high)
  - Source country has primary (exclusive) right to tax normal return to tangible capital.
  - Residence country has right to reduced or minimum tax on mobile rents
- The rules do not work this way in reality because of expense allocations and the foreign tax credit.
- Criticisms to come.

Incentive Effects of International Provisions - on U.S. MNC



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Leak-Driven Law

Shu-Yi Oei & Diane Ring
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Eight Significant Leaks

- UBS/LGT
- HSBC Suisse
- Julius Baer
- British Havens leak
- LuxLeaks
- Panama Papers
- Bahamas
- Paradise Papers

UBS

Who:

*Birkenfeld former UBS banker

*Blew Whistle: client names, accounts, bank actions

*IRS, DOJ, SEC, Senate

*Jail, Whistleblower award

Result:

*FACTA,

*Global expansion

*CRS

Panama Papers

Who:

*Anonymous data source

*Gave to German Newspaper

*Work with ICIJ

*11.5 million records from Panamanian Law Firm covering 40 years

*21,000 offshore entities, 200+ countries, major banks, political and other elites implicated

Result:

*Political fallout

*Investigations

*Focus on reforms regarding beneficial ownership registries, exchanges

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LuxLeaks

Who:

*Deltour- French citizen, PWC employee

*Copied tax rulings, shared with French journalist

*Work with ICIJ- published about 500 rulings

*Exposed ruling practices regarding multinationals

Result:

*Attention to ruling practices in Luxembourg and beyond

*Exchange agreed

*EC - Consultation

*EP- 2 special committees, recommendations

* EP European Citizenship Award

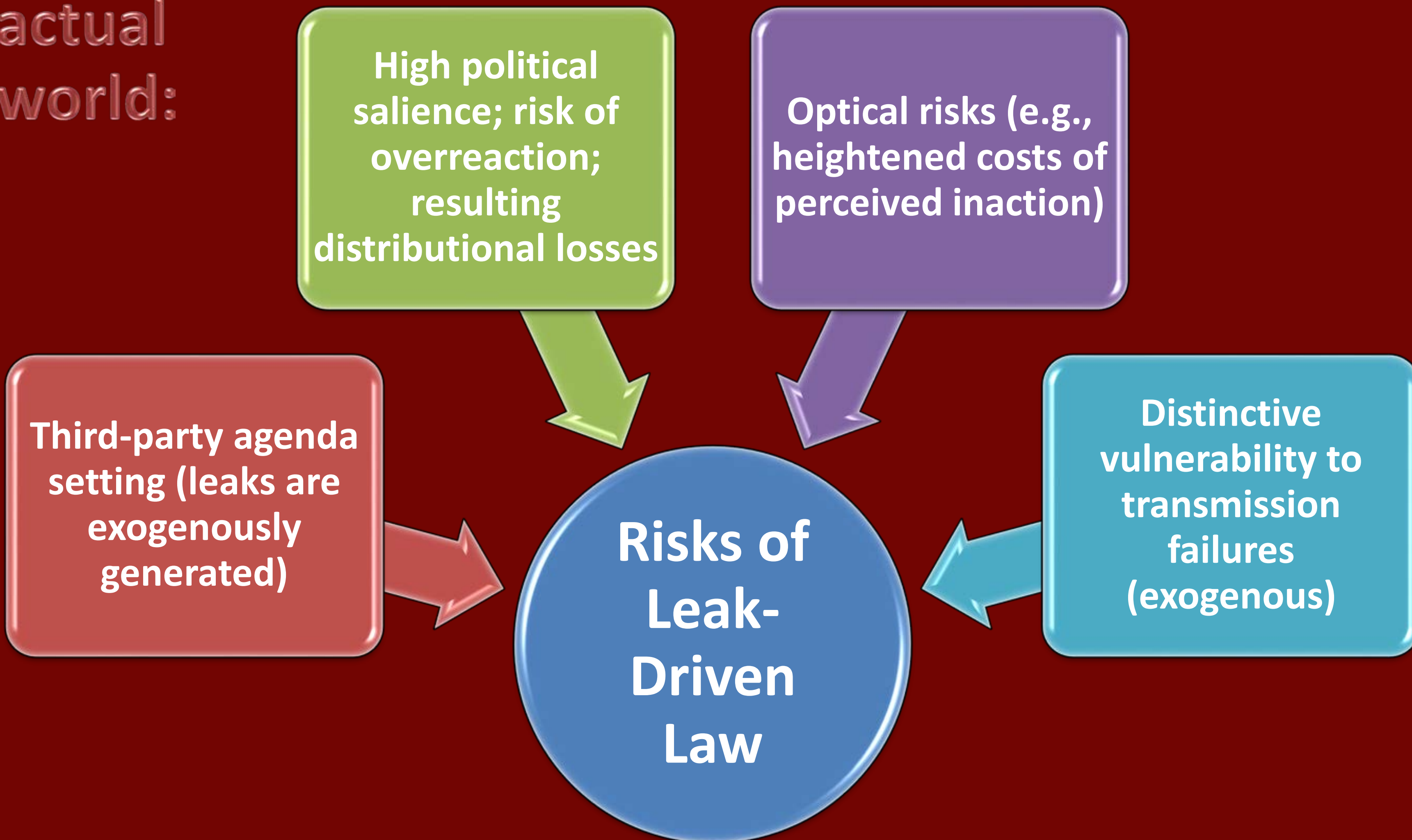
*Charges

*Increased support for CCTB, beneficial ownership registries, WB protection, increased tax transparency

In a rational world:

FREE AUDIT + DETER TAXPAYERS + DISTRIBUTIVE GAINS + SALIENCE; IMPETUS TO REFORM = BENEFITS OF LEAK DRIVEN LAW

In the actual world:



Case Studies:

- Role of ICIJ in Panama Papers and Other Leaks
- Time Lags in Transmission of HSBC Data
- FATCA and US Offshore Enforcement

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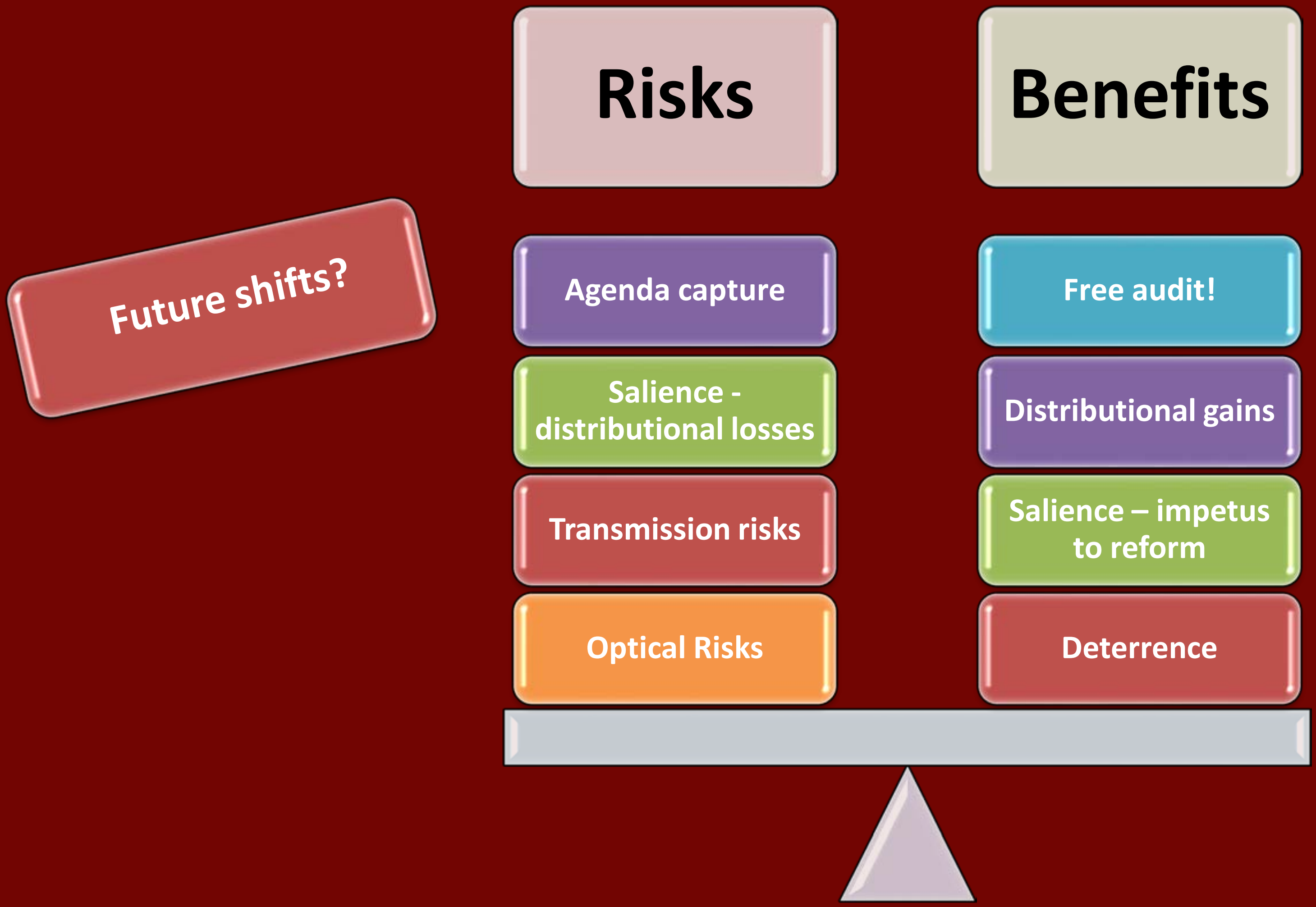

U.S. Nexus Debate – *South Dakota v. Wayfair*

- South Dakota enacts 2016 law to challenge U.S. Supreme Court Doctrine
  - any seller with annual sales greater than $100,000 or 200 separate transactions in South Dakota is required to collect sales tax
- September 2017, South Dakota S. Ct held state must follow U.S. Supreme Court precedent, law cannot be enforced
- January 2018, U.S. Supreme Court granted certiorari
- Issue: Should *Quill v. North Dakota*'s physical presence requirement be abrogated?
  - *Quill* requires a business to have a physical presence in a state to be required to collect sales tax on purchases from in-state consumers

U.S. Nexus Debate – *South Dakota v. Wayfair*

- South Dakota argues Physical Presence rule should be replaced with Economic Nexus standard
    - Physical Presence is unworkable due to increased use of online retail
    - Unanticipated revenue losses from physical presence rule
    - Gives online retailers a competitive advantage
  - Reliance on *Quill* not justified as competitive circumstances and economic understandings have evolved in 25 years
  - Concerns over undue burdens on small businesses unjustified
  - Other precedent will preclude overly complex and burdensome regimes
- Sixty Tax Profs and Economists filed an Amicus Brief in support
  - Development of tax automation software means dramatic reduction in sales tax compliance costs for multistate retailers

U.S. Nexus Debate – *South Dakota v. Wayfair*

- Wayfair's main arguments
  - No justification for declining to follow precedent, Congress can change the Court's decisions if needed
  - Retailers have reasonably relied on *Quill*, due to the complexity of determining nexus for sales tax
  - South Dakota law affects many small businesses
  - Issue should be left to Congress

U.S. Nexus Debate – *South Dakota v. Wayfair*

"The Court should resolve this case by making clear that an out-of-state Internet retailer's virtual presence within a State is a sufficient ground for requiring the retailer to collect sales or use taxes owed by its in-state customers."

-Brief for the United States as Amicus Curiae

U.S. Response to the EU Digital Tax Proposals

- U.S. Treasury Secretary Steve Mnuchin's immediate response:

  > "The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers."

- Mnuchin supports international cooperation to address broader tax challenges resulting from the modern economy

U.S. Response to the EU Digital Tax Proposals

Digital Services Tax

- Ring Fencing
  - U.S. is firmly opposed to any proposals that single out digital companies for taxation (Treasury Department International Tax Counsel Douglas Poms)
  - If new rules are introduced, they should apply to both traditional and digital business models to avoid creating market distortions
- Discourages Innovation
- Harms Workers and Consumers

U.S. also opposes creation of Permanent Establishment based on user contributions: user data is just another input that goes into production and should be treated the same way

Issues with the EU Digital Tax Proposals

- Possibility of double taxation
  - When tax on revenues is combined with VAT and international level of income tax
  - Outside the scope of tax treaties
- Negative impact of gross taxation
  - Inability of businesses with low margins to absorb a tax on gross revenue
  - Large part of the digital economy is not profitable, ex: Spotify, Twitter
- Broad scope
  - Common view that raw data retrieved has no value alone, data must be exploited to provide value to a company
  - Difficult to determine which activities occurring within a country create value for the company making sales there
  - Failure to narrow focus results in businesses paying more than their fair share

Issues with the EU Digital Tax Proposals

- Subjects businesses to negative tax consequences for choosing one method of production or distribution over another
- Discrimination
  - Thresholds target world's largest participants, located mainly in the U.S. and China
  - Possibility of unequal treatment of domestic and non-resident businesses if non-resident businesses have been sufficiently taxed elsewhere
- Distorts consumer choices
  - Taxes directed toward specific goods are often used to correct market failures or benefit public welfare
  - OECD has acknowledged that growth in the digital economy benefits the public in terms of economic growth, employment, and general well-being

Problems with the EU Digital Tax Proposal

- Complications in international tax cooperation: third countries may feel international discussions are not respected
- Lack of international consistency in this area may lead to inefficiencies and increased compliance burdens
- Revisiting the long-established balance between residency-based versus source-based taxation
- Shifting taxing jurisdiction away from countries of development and production towards countries of consumption
- Taxation on the basis of customer location is a radical departure from long-established principles of direct taxation and does not reflect value creation.

Economic Arguments Against Turnover Taxes

- Threatens growth of the digital economy, as a result of the use of a turnover tax
- No relation to profitability and therefore does not accurately represent ability to pay tax
  - While two companies may generate equal profits, the company with a lower margin pays more tax
  - Creates an uneven playing field and distorts competition
- Burden generally passed on to consumers, resulting in significant price increases, as businesses focus more on higher margin
  - Or businesses may leave markets where price increases are not an option
- Cascading effect may deter business to business sales

OECD Guidance for Countries Looking to Introduce Interim Measures

- Actions should:
  - Comply with a country's international obligations
  - Be temporary, targeted, and minimize over-taxation
  - Minimize impact on start-up, business creation, and small businesses, and
  - Minimize cost and complexity