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CONSTRUCTIVE DIALOGUE: BEPS AND THE TCJA

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ABSTRACT

US international tax law is commonly conceived as developed in the US and influencing the development of other countries' international tax law. This paper will argue that in the case of the TCJA, the US legislation was heavily influenced by the OECD BEPS project, and that the continuing OECD work in Pillars I and II is likely to have a similar influence on the future development of US international tax law.

1. Introduction

From its inception, the international tax regime was heavily influenced by the United States. The regime is traditionally traced back to the work of the four economists for the League of Nations in 1923, who came up with the original compromise underlying the tax treaty network, i.e., that passive income should be taxed primarily at residence and active income primarily at source (the "benefits principle"). Arguably, this compromise between the claims of residence and source countries was made possible by the US unilateral adoption of the foreign tax credit in 1918, because the US (already the world's largest capital exporter) was (unlike the UK) willing to cede taxing jurisdiction to the source by allowing a dollar for dollar credit (originally without limitation). Edwin Seligman, the US representative to the four economists, used the credit to persuade them to adopt the benefits principle. In addition, because the US rejected exemption to alleviate double taxation, it laid the ground work for the single tax principle, first embodied in the original League of Nations model treaty of 1927 (e.g., imposing withholding tax on interest unless it was taxed at residence).

This state of affairs continued up through and including the Great Recession of 2008-2010, which brought us FATCA and its international progeny the CRS. But in the past decade the direction of influence has been reversed. The original OECD BEPS project (BEPS 1) of 2013-2015 was led by the EU, not by the US, and its influence can be seen in both the 2016 US model and the TCJA. The current BEPS effort (BEPS 2) is also primarily led by Europe in Pillar I, which reacts to the adoption of DSTs, but the influence of TCJA can be seen in Pillar 2. However, Pillar 2 is an improvement of the TCJA and is likely in turn to influence reform of the TCJA. The current state of play can thus be characterized as a constructive dialogue between the US and the EU (and not, as some would claim, a "tax war").

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In what follows, I will first describe the traditional US role of constructive unilateralism (part 2), then discuss BEPS 1 and the 2016 US model (part 3), then turn to the TCJA (part 4). Part 5 concludes by discussing how BEPS 2 can if it succeeds lead to further US reforms.

2. The Traditional US Role: Constructive Unilateralism, 1918-2010.

Traditionally, the US has been a leader, not a follower, in international taxation. This part describes ten instances of US international tax leadership from 1918 to 2010, all of which were adopted by the US unilaterally but then followed by other countries and/or the OECD.

a. The Foreign Tax Credit

Following the end of World War I, capital importing and capital exporting countries engaged in a vociferous debate on who should bear the burden of preventing double taxation of cross-border income. Capital exporters like the UK called for abolishing source-based taxation, and would at best give a deduction for foreign taxes. Capital importers like Italy argued for territorial taxation.

The US was already the world's leading capital exporter in 1918. Despite that, it adopted a middle position- impose world-wide taxation, but give a foreign tax credit for taxes imposed at source (limited from 1921 to the US tax rate, lest it incentivize source countries to raise their rates at the expense of the US Treasury). The US rejected territoriality because it would lead to non-taxation of income that was not taxed at source. But it also rejected the UK view that only a deduction should be available for foreign taxes, because that would lead to preference for domestic over foreign investment (since the foreign tax would be an added burden even if it were deductible).

What explains the US position, as compared to the UK one? The answer presumably lies in the different relationship of business and government in the two countries. The US position was the one that took care of the interest of the fisc but also respected the needs of US multinationals to avoid double taxation, while the UK only addressed its fiscal needs (of course, the US could also afford to be more generous).

When Columbia Professor Edwin Seligman attended the meetings of the four economists appointed by the League of Nations to study this issue in 1923, he was therefore in a good position to broker a compromise between the positions of the capital exporters and importers. The result was that primacy was given to the tax of the source country on active income, but not on passive income, and the foreign tax credit became the norm for worldwide jurisdictions.

It is commonly argued that most other OECD members are territorial, but this is a mistake. Territoriality merely means that dividends from active income are not taxed

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upon repatriation. But most “territorial” jurisdictions now have CFC rules, which mean that they tax some types of income currently with a foreign tax credit. It is hard to find any purely territorial jurisdictions among our major trading partners.

Thus, I believe that the foreign tax credit is our first example of US constructive unilateralism. The US adopted it unilaterally without the need for a treaty, and most major jurisdictions followed suit. In the absence of unilateral US action, it is likely that the international tax regime would not have arisen, and a lot of double taxation would have been the result.

In recent years, some academics have called for abolishing the US Foreign Tax Credit and replacing it with a deduction. Prof. Shaviro, for example, has proposed such a regime, in which the problem of double taxation is addressed by adjusting the US tax rate on foreign source income so that a deduction achieves the same neutrality between domestic and foreign investment as a credit. But even assuming that such adjustments are possible on an ongoing basis, it seems to me that Shaviro ignores the likely response of our trading partners. If we abandon the credit, so would others, and it is hard to imagine a situation in which this would not result in disincentives to cross-border investment since it is impossible to adjust all the rates at the same time. The entire edifice built into the treaties of either giving a credit or an exemption would in all probability not survive such a unilateral US move. Constructive unilateralism would be replaced by destructive unilateralism.

b. Foreign Investment Funds

The US adopted the first Foreign Investment Fund, or “incorporated pocketbook”, legislation as the foreign personal holding company (FPHC) rules in 1935. The legislation was a result of hearings that revealed numerous instances of wealthy US individuals transferring passive income to foreign corporations that they controlled. While the FPHC rules were abolished in 2004, they were replaced by the even more stringent Passive Foreign Investment Company (PFIC) rules from 1986 onward. The PFIC rules are remarkable because they do not require control from the US. Most of the recent criminal tax evasion convictions of US resident individuals come about because they do not comply with the PFIC rules when setting up corporations in tax havens.

Other countries followed suit. After the relaxation of exchange controls in the 1980s, most developed countries and many developing ones adopted Foreign Investment Fund (FIF) rules that are modeled after the FPHC and PFIC rules. In a globalized world, it is impossible to maintain progressivity in the income tax without such a rule. Even purely territorial jurisdictions like most Latin American countries found it necessary to adopt FIF rules in conjunction with global taxation in the 1990s.

This is therefore another example of constructive unilateralism. The US led, and most of the world followed, at least on paper. Unfortunately resource constraints mean that

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many countries are unable to effectively enforce their FIF rules. However, the rise of automatic exchange of information (discussed below) promises to put some more teeth into these rules. And the existence of the rules ensures that if people are caught evading they can be prosecuted.

c. Controlled Foreign Corporations

Before 1961, no country taxed the foreign source income of subsidiaries of its multinationals, because residence countries believed they lacked both source and residence jurisdiction over foreign source income of foreign corporations. However, in 1961 the Kennedy Administration proposed taxing all income of "controlled foreign corporations" (CFCs) by using a deemed dividend mechanism that was copied from the FPHC rules.

While this proposal was rejected, the resulting compromise (Subpart F, 1962) aimed at taxing income of CFCs that was unlikely to be taxed by source countries either because it was mobile and could be earned anywhere (passive income) or because it was structured to be earned in low-tax jurisdictions (base company income).
Initially, the adoption of Subpart F seemed to have put US-based multinationals at a competitive disadvantage, because no other country had such rules. But gradually this picture changed. The US was followed by Germany (1972), Canada (1975), Japan (1978), France (1980), United Kingdom (1984), New Zealand (1988), Australia (1990), Sweden (1990), Norway (1992), Denmark (1995), Finland (1995), Indonesia (1995), Portugal (1995), Spain (1995), Hungary (1997), Mexico (1997), South Africa (1997), South Korea (1997), Argentina (1999), Brazil (2000), Italy (2000), Estonia (2000), Israel (2003), Turkey (2006), and China (2008). Many other countries, such as India, are considering adopting such rules. As a result, most of our trading partners now have CFC rules.

Moreover, the later adopters improved on the US in two principal ways. First, they rejected the deemed dividend mechanism, which can lead to many unforeseen complications, in favor of taxing the shareholders on a pass-through basis. Second, they generally explicitly incorporate the effective foreign tax rate into the determination whether a CFC will be subject to current tax. This is better than the US rule that is based solely on the type of income, because after 1980 it became quite easy to earn active income that is not subject to tax.

The result is that the CFCs of EU-based multinationals are generally subject to tax at similar or higher rates than US-based ones, despite the non- taxation of dividends from active income under territoriality. This is therefore a classic example of constructive unilateralism. The US led and others followed, and the end result is that most multinationals are subject to similar effective tax rates, with no competitive disadvantage or advantage. The result is a world in which there is much less double non-taxation than in the absence of CFC rules.

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Unfortunately, in the US Subpart F was critically undermined before the TCJA by the adoption of check the box (discussed below) and the CFC to CFC exception, resulting in $3 trillion of low-taxed accumulated earnings offshore by US multinationals. This cannot happen in other countries with tougher CFC rules, and is a major part of the explanation why despite rampant tax competition most OECD members did not see the sharp drops in overall corporate tax revenues that are seen in developing countries.

d. Transfer Pricing

The US first adopted statutory language governing transfer pricing in 1921, and the "arm's length standard" that still applies dates to the 1930s, but both lacked meaningful content until the adoption of the original transfer pricing regulations in 1968. These regulations incorporated the three "classical" transfer pricing methods of comparable uncontrolled price, cost plus and resale price.

By 1977, the OECD adopted transfer pricing guidelines that followed closely the three classical methods. These US methods are still the gold standard for transfer pricing and are accepted worldwide, including by developing countries that are not members of OECD.

By the late 1980s, however, the US became dissatisfied with the classical methods because of the difficulty of finding adequate comparables for most transactions. A GAO study from 1991 found that over 90% of transfer pricing cases were not resolved on the basis of the classical methods. As a result, the US in 1995 adopted two new profit-based methods, the Comparable Profits Method and Profit Split, that now govern the majority of transfer pricing cases.

Remarkably, the OECD followed with revised transfer pricing guidelines within months of the new US regulations, which likewise incorporated the two new methods. There was some resistance, however, and initially the new methods were treated as methods of last resort (the Germans in particular were concerned about the lower standard of comparability in the profit based methods). By the 2000s, however, the OECD changed its mind and accepted the new methods as equal to the classical ones. The OECD now follows the US "best method rule" under which there is no hierarchy of methods. Other countries have likewise followed the new OECD guidelines.

Another example of constructive unilateralism in this context is APAs, a US innovation that most countries have now adopted, including multilateral APAs. Despite significant critiques due to the secrecy involved, APAs have overall been a positive development for tax administrations and multinationals alike.

I have long been a critic of the arm's length standard, and regret that the US did not follow through on legislation adopted by the House of Representatives in 1962 that would have shifted the US to global formulary apportionment. The refusal to do so is no

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doubt another example of the influence of US businesses on US tax policy. And yet, it is clear that transfer pricing is an example of constructive unilateralism, because the entire world (almost-Brazil is the exception) follows rules that were originally developed by the US. While transfer pricing is difficult, the alternative of no rules would have been much worse.

e. Limitation on Benefits

The idea of limiting the benefits of treaties to bona fide residents of the treaty countries originated with the first US model treaty of 1981. While tax treaties were initially aimed at preventing double taxation, by the 1970s it was clear that they frequently were enabling double non-taxation to occur because non-treaty country residents could use it to reduce taxation at source by setting up corporations as nominal residents of treaty countries. The US took the position that source taxation should not be reduced unless the income was in fact taxed at residence.

Since 1984, the US has insisted on including LOBs in all of its tax treaties (and also made it a treaty override in some contexts). It also has anti-conduit rules in its domestic legislation. Other countries were initially reluctant, but had to agree (even the Dutch went along, because this was non-negotiable, although the specific LOB in the US-Netherlands treaty is distinctly more porous than the US model one). Eventually, the OECD included a model LOB in the commentary on article 1 of its model treaty, and now in the context of BEPS this language will be moved into the article itself, in conjunction with a declaration that the primary purpose of the treaty is to prevent both double taxation and double non-taxation. Thus, the US view has prevailed and is now generally accepted in the treaty context. It is also clear now that the purpose of LOB is not just to prevent a “treaty with the world” but to prevent double non-taxation. While some countries (e.g., India) still resist, the US view is now the predominant one.

f. Foreign Investment in Real Property

The US adopted FIRPTA in 1980, and made it a treaty override, since it taxes capital gains on real property at source contrary to article 13 of the models. The US also insisted on applying the tax to sales of stock in US corporations over 50% of whole value is US real estate.

The OECD initially resisted, condemning the treaty override in a 1989 report. But then other countries began adopting similar provisions by treaty override (e.g., Australia), and by now the OECD model has been changed to reflect the US position, including the real property holding company rule.

I do not like FIRPTA and would abandon it, because I do not see the point of taxing real property and not taxing large participations (the real property is immobile, but acquisitions of US companies can lead to outward migration of IP). Moreover, the

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FIRPTA tax can be avoided by, e.g., holding the real property through a foreign corporation and selling the shares. Nevertheless, it is clear that in this case as well the US view has been accepted by the rest of the world, which sets great store on taxing real property (including minerals) at source.

g. Portfolio Interest Exemption

The US adopted the portfolio interest exemption in 1984, against the background of a growing federal deficit and a wish to enable foreign investors to lend to the US government and US corporations without being subject to treaty exchange of information provisions. This move has generally been seen as a mistake (Charlie McLure, one of its authors, has regretted it in public) because it has enabled US residents to pretend to be foreigners and escape US tax, and because it generally supports tax evasion. Thus it is more an example of destructive than constructive unilateralism. But there is no question that it had a major impact on the rest of the world: No country can easily afford to impose tax on outbound interest while the biggest market does not. Even the EU, which with its Savings Directive has made a serious effort to tax intra-EU interest payments, exempts payments to non-EU residents (e.g., US residents, so that the US and the EU each aid and abet tax evasion by residents of the other, although this may be changing now as a result of FATCA- see below).

h. Branch Profit Tax

The branch profit tax (BPT) is designed to treat branches the same as subsidiaries by imposing withholding tax on "dividend equivalent amounts" of the branch, calculated by reference to increases or decreases in the branch's net equity. It is a complicated rule, and in my opinion an unnecessary one, since dividends are not deductible and the income has been taxed once already at the corporate level (as effectively connected income of the branch). Nevertheless, in this case as well other countries (e.g., Germany) have adopted similar rules, and they may be perceived as more necessary since branches and subsidiaries are more similar with the rise of LLCs and check the box. The US has incorporated the BPT in its tax treaties, and the OECD permits it in the OECD model.

i. Anti-Hybrid Rules

While the US has committed a spectacular act of destructive unilateralism with check the box, it did subsequently adopt an anti-hybrid rule in the treaty context, determining that it should not be possible to achieve double non- taxation by having an LLC treated as a branch paying interest for US purposes but as a corporation paying exempt dividends for Canadian purposes. The Canadians went along even though this too was a treaty override, revising the treaty accordingly. Other countries (e.g., the UK) subsequently adopted broader anti-hybrid rules.

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j. FATCA

The most spectacular and impressive recent example of constructive unilateralism is FATCA. FATCA was initially adopted in 2010 in response to the UBS case, and on the face of it FATCA is just about requiring foreign financial institutions to report accounts controlled by US citizens or residents directly to the IRS. Because FATCA had real teeth (non-complying FFIs that derive US source income are subject to 30% withholding) and because it violated local privacy laws, it initially met with huge resistance. But the US Treasury was able to negotiate Intergovernmental Agreements with many countries to permit FFIs to transfer the information to their own governments, which would then share it under treaties. That, in turn, led to the development of standard information exchange rules that culminated in the Multilateral Agreement on Administrative Assistance in Tax Matters (MAATM), which has now been signed by over 100 countries (not including the US) and which provides for automatic exchange of information with no bank secrecy or dual criminality exceptions.

Thus, a provision that has been widely decried as a unilateral US power grab has now led to the most extensive multilateral agreement in tax matters. There is no better example of the power of US leadership or of constructive unilateralism.

3. BEPS 1 and the 2016 US Model

Following FATCA, the next major development in international taxation was BEPS 1, from 2013 to 2015. While the US participated in BEPS 1, it was not the leader, ceding this role to the EU. The main reason was that the Great Recession was more severe in the EU than in the US and the austerity policies adopted by EU government led to public pressure on politicians to ensure than MNEs pay adequate tax. No such public pressure developed in the US despite similar Congressional hearings (compare, e.g., the Starbucks case in the UK to the Apple hearing in the US Senate- Starbucks was condemned for legally reducing its UK tax while Apple was celebrated for doing the same in the US).

a. BEPS 1.

BEPS 1 was an implementation of the single tax principle, which underlay US international taxation from 1918 to 1981 but was mostly forgotten in the US in the era of tax competition, the portfolio interest exemption and check the box. In turn, it influenced the US, as can be seen in the 2016 version of the US model.

The reliance of BEPS 1 on the single tax principle can be seen from the new preamble to the OECD model tax treaty:

(State A) and (State B)...Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital **without creating**

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opportunities for non-taxation or reduced taxation through tax evasion or avoidance...(emphasis added)

This language embodies the OECD and G20's official commitment to preventing both double taxation and double non- taxation, i.e., to the single tax principle.

In introducing the final BEPS package on October 5, 2015, OECD Secretary General Angel Gurria stated that:

"Base erosion and profit shifting affects all countries, not only economically, but also as a matter of trust. BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis and create more and better opportunities for all. But beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide. The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: they will **put an end to double non-taxation**, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective".

While this is no doubt over optimistic, it is clear that BEPS 1 was intended to implement the single tax principle. This goal can be seen in all of the BEPS action steps:

Action 1: Addressing the Tax Challenges of the Digital Economy

This step is designed to address the ability of multinationals to avoid taxation of active income at source by selling goods and services into an economy without having a PE. In a world in which most residence jurisdictions exempt or defer taxation of active income changing the PE physical presence standard is essential to prevent double non-taxation.

Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements

This step is obviously designed to address double non- taxation by limiting tax arbitrage transactions designed to utilize hybrid mismatches to create double non-taxation. Check the box is a target.

Action 3: Designing Effective Controlled Foreign Company Rules

This step is intended to enforce effective residence-based taxation of income that is not taxed at source by limiting the scope of exemption and deferral to income that is subject to source based taxation.

Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

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This step is designed to enforce source based taxation of active income by limiting interest and related deductions that erode the corporate tax base without corresponding inclusions at residence.

Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

This step is intended to reinforce source based taxation of active income by putting limits on harmful tax competition involving special regimes like patent boxes and cashboxes, and by requiring real investment that raises the transaction costs.

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

This action adopts the US LOB position that treaty benefits should not result in reduction of tax at source unless there is effective taxation at residence, including a "primary purpose test" that states that the purpose of treaties is to prevent both double taxation and double non-taxation.

Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

This action reinforces source based taxation of active income and prevents the Shifting of such income into low tax jurisdictions through commissionaire and similar arrangements.

Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation

These actions build on earlier OECD work by limiting the ability to shift income to low tax jurisdictions by transfer pricing.

Action 11: Measuring and Monitoring BEPS

This action attempts to incentivize governments to act on BEPS by measuring its Magnitude (between $100 and $240 billion reach year in tax avoided).

Action 12: Mandatory Disclosure Rules

This action seeks to prevent secret rulings that enable multinationals to pay very low effective tax rate in countries that appear to have high corporate tax rates.

Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

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This action seems to bolster transfer pricing by requiring country by country reporting by multinationals, so that tax avoidance can be measured and source taxation of active income upheld.

Action 14: Making Dispute Resolution Mechanisms More Effective
This action builds on previous OECD work on mandatory arbitration in tax treaties to prevent double taxation. It is a necessary corollary to the steps that limit double non-taxation.

Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

This action is intended to improve coordination of the previous steps.

Overall BEPS 1 was a very impressive achievement in a very short span of time. While BEPS will not eliminate double non-taxation any time soon, it demonstrated significant political commitment by the G20 and OECD to the single tax principle. It builds on earlier OECD actions like the commentary on article 1 that incorporates LOB principles, and that according to OECD applies to all treaties that include article 1, which is every tax treaty.

b. The New US Model (2016)

Anticipating the outcome of BEPS, the US in May 2015 released several proposed amendments to its model tax treaty, all of which are consistent with the single tax principle. Clearly, in this case the influence was in the opposite direction: These changes implement BEPS 1, which was not led by the US.

1. **Treaty Exempt PEs**

New Article 1 Section 7 excludes from the withholding tax reductions of the treaty payments to a permanent establishment of a company of the treaty partner in a third state if—

the profits of that permanent establishment are subject to a combined aggregate effective rate of tax in the [treaty partner state] and the state in which the permanent establishment is situated of less than 60 percent of the general rate of company tax applicable in the [treaty partner state]

or if the PE is situated in a third state that does not have a tax treaty with the US and the PE is not subject to tax in the treaty partner.

This provision is intended to prevent treaty benefits to accruing to a company resident in a treaty party that applies territoriality so as to exclude the profits of branches in low-tax jurisdiction. The effect of the provision would be to impose full 30% withholding on

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payments to such branches, consistently with the single tax principle and with the branch rule of Subpart F.

2. **Expanded LOB**

The new LOB article is a significant tightening of existing LOB rules. For example, the requirement that if a company is traded on a stock exchange, that stock exchange must be in the same country that the company is in, is intended to address "inversion" transactions in which US companies inverted to Bermuda, had the board meet in Barbados to qualify under the US-Barbados treaty, and claimed exemption from LOB because they were publicly traded on the NYSE.

In addition, similarly to the 1981 LOB, treaty benefits are denied to a company unless—
ii) with respect to benefits under this Convention other than under Article 10 (Dividends), less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property), either to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph **or to persons that meet this requirement but that benefit from a special tax regime in their Contracting State of residence with respect to the deductible payment**. (emphasis added).

"Special tax regime" is a newly defined term:
l) the term "special tax regime" with respect to an item of income or profit means any legislation, regulation or administrative practice that provides a **preferential effective rate of taxation** to such income or profit, **including through reductions in the tax rate or the tax base**. With regard to interest, the term special tax regime includes notional deductions that are allowed with respect to equity. However, the term shall not include any legislation, regulation or administrative practice:
i) the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof;
ii) that, with regard to royalties, satisfies a substantial activity requirement;
iii) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises);
iv) that applies principally to persons that exclusively promote religious, charitable, scientific, artistic, cultural or educational activities;
v) that applies principally to persons substantially all of the activity of which is to provide or administer pension or retirement benefits;
vi) that facilitates investment in entities that are marketed primarily to retail investors, are widely-held, that hold real property (immovable property), a diversified portfolio of

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securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established; or vii) that the Contracting States have agreed shall not constitute a special tax regime because it does not result in a low effective rate of taxation (emphasis added).

This means that the withholding tax reductions of the treaty will not apply to a company 50% or more of its income (or of the income of its consolidated group) is paid in deductible payments either to residents of third countries or to a company in the treaty partner country that is subject to a low effective tax rate because of a "special tax regime." As in the 1981 LOB, this provision makes it clear that the purpose of the LOB is to enforce the single tax principle, not just to prevent a treaty with the world.

3. **Anti-inversion rules.**

New language is added to articles 10, 11, 12 and 21 to the effect that dividends, interest, royalties and other income paid by an "expatriated entity" can be subject to 30% withholding tax for a period of ten years after the inversion that created it. Since most "second wave" inversions are to treaty jurisdictions and the treaty is essential to the purpose of the inversion, which is to generate double non-taxation by stripping earnings out of the US into low tax jurisdictions (e.g., through the Netherlands or Ireland, as in the infamous double Irish Dutch sandwich), this will be a significant blow to inversions when it is included in actual treaties.

4. **Special Tax Regimes**

The newly defined "special tax regime" will, in accordance with the Technical Explanation, also prevent reduction of withholding taxes under articles 11, 12 and 21. The Technical Explanation provides that:

Subparagraph 1(l) defines the term "special tax regime" with respect to an item of income. The term is used in Articles 11 (Interest), 12 (Royalties), and 21 (Other Income), each of which denies treaty benefits to items of income if the resident of the other Contracting State (the residence State) beneficially owning the interest, royalties, or other income, is related to the payor of such income, and benefits from a special tax regime in its residence State with respect to the particular category of income. This rule allows the Contracting State in which the item of income arises to retain its right to tax the income under its domestic law if the resident benefits from a regime in the residence State with respect to a category of income that includes the item of income that results in low or no taxation. The term "special tax regime" also is used in Article 22 (Limitation on Benefits) for the purposes of the so-called "derivative benefits" rule in paragraph 4 of that Article.

The application of the term "special tax regime" in Articles 11, 12 and 21 is consistent with the tax policy considerations that are relevant to the decision to enter into a tax

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treaty, or to amend an existing tax treaty, as articulated by the Commentary to the OECD Model, as amended by the Base Erosion and Profits Shifting initiative. In particular, paragraph 15.2 of the introduction of the OECD Model now provides: "Since a main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross- border services, trade and investment, the existence of risks of double taxation resulting from the interaction of the tax systems of the two States involved will be the primary tax policy concern. Such risks of double taxation will generally be more important where there is a significant level of existing or projected cross-border trade and investment between two States. Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between two States and it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State. Where a State levies no or low income taxes, other States should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy."

The term "special tax regime" means any legislation, regulation, or administrative practice that provides a preferential effective rate of taxation to interest, royalties or other income, including through reductions in the tax rate or tax base. In the case of interest, the term includes any legislation, regulation, or administrative practice, whether or not generally available, that provides notional deductions with respect to equity. For purposes of this definition, an administrative practice includes a ruling practice.

For example, if a taxpayer obtains a ruling providing that its foreign source interest income will be subject to a low rate of taxation in the residence State, and that rate is lower than the rate that generally would apply to foreign source interest income received by residents of that State, the administrative practice under which the ruling is obtained is a special tax regime.

Paragraph 2 of the Protocol provides a list of the legislation, regulations, and administrative practices existing in the other Contracting State at the time of the signature of the Convention that the Contracting States agree are "special tax regimes" within the meaning of paragraph 1(l) of Article 3.

This is clearly consistent with the single tax principle and with the original US LOB of 1981, which has been eroded in subsequent versions but is now returning with full force to deny treaty benefits (reductions in source taxation) in cases that the effective tax rate at residence is too low.

5. **Subsequent Changes.**

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A new article 28 provides that—

1. If at any time after the signing of this Convention, the general rate of company tax applicable in either Contracting State falls below 15 percent with respect to substantially all of the income of resident companies, or either Contracting State provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties), the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) may cease to have effect pursuant to paragraph 4 of this Article for payments to companies resident in both Contracting States.
2. If at any time after the signing of this Convention, the highest marginal rate of individual tax applicable in either Contracting State falls below 15 percent with respect to substantially all income of resident individuals, or either Contracting State provides an exemption from taxation to resident individuals for substantially all foreign source income (including interest and royalties), the provisions of Articles 10, 11, 12 and 21 may cease to have effect pursuant to paragraph 4 of this Article for payments to individuals resident in either Contracting State.
3. For purposes of this Article:
a) the allowance of generally available deductions based on a percentage of what otherwise would be taxable income, or other similar mechanisms to achieve a reduction in the overall rate of tax, shall be taken into account for purposes of determining the general rate of company tax or the highest marginal rate of individual tax, as appropriate; and
b) a tax that applies to a company only upon a distribution by such company, or that applies to shareholders, shall not be taken into account in determining the general rate of company tax.
4. If the provisions of either paragraph 1 or paragraph 2 of this Article are satisfied by changes in law in one of the Contracting States, the other Contracting State may notify the first- mentioned Contracting State through diplomatic channels that it will cease to apply the provisions of Articles 10, 11, 12 and 21. In such case, the provisions of such Articles shall cease to have effect in both Contracting States with respect to payments to resident individuals or companies, as appropriate, six months after the date of such written notification, and the Contracting States shall consult with a view to concluding amendments to this Convention to restore an appropriate allocation of taxing rights.
The Technical Explanation provides that--
The negotiation of the Convention took into account the desire of the two Contracting States to allocate taxing rights between them in a manner that would alleviate double taxation that could otherwise result if cross-border income, profit or gain were taxed under the domestic laws of the two Contracting States. The Contracting States recognize that certain subsequent changes to the domestic laws of one or both of the Contracting States that lower taxation could reduce the risk of double taxation but in addition increase the risk that the Convention would give rise to unwanted instances of low or no taxation. In addition, such subsequent changes in law could draw into question the

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continued appropriateness of the allocation of taxing rights that was originally negotiated in the Convention.

Article 28 addresses this possibility by providing that if, at any time after the signing of the Convention, either Contracting State enacts certain changes to domestic law that could implicate the terms of the Convention, certain benefits of the Convention may cease to have effect, and if so the Contracting States shall consult with a view to amending the Convention in a way that would restore an appropriate allocation of taxing rights.

Article 28 is consistent with the tax policy considerations that are relevant to the decision to enter into a tax treaty, or to amend an existing tax treaty, as articulated by the Commentary to the OECD Model, as amended by the Base Erosion and Profits Shifting initiative.

Once again the consistency of this provision with the single tax principle is explicit. The goal is to address subsequent harmful tax competition provisions that erode residence-based taxation in the treaty partner.

Overall these provisions show that the current US model was heavily influenced by BEPS 1, rather than the other way around.

4. The TCJA

The TCJA was originally driven by the desire of the US MNEs to adopt a participation exemption and enable them to repatriate their “trapped income”, which by 2017 amounted to about $3 trillion. This in turn was explicitly based on the fact that most other OECD countries had such an exemption, and in particular that Japan and the UK had recently switched to an exemption from worldwide taxation. Thus, in this case the US was explicitly the follower and not the leader.

Much of the rest of the TCJA followed because (a) domestic US corporations wanted a rate cut that will compensate them from not having exempt foreign income, and (b) pass throughs wanted a rate cut to compensate them for not being corporations. The combination of these steps (the participation exemption, cutting the corporate rate from 35% to 21%, and the 199A deduction) led to massive revenue losses, and that in turn required revenue raisers to keep the ten year cost of the overall package below $1.5 trillion, as required by the budget resolution underlying reconciliation (which was necessary to avoid a Senate filibuster). Much of the revenue came from the international provisions in the form of the one time tax on offshore income, GILTI and BEAT, as well as the new limits on the interest deduction that apply both domestically and internationally.

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On the face of it, the participation exemption represents a glaring deviation from the "single tax principle", which underlies BEPS. The single tax principle states that all income should be subject to tax once, at the residence country rate if it is passive income and at the average source country rate if it is active income. The participation exemption violates this principle because it exempts dividends from residence taxation even if they were not taxed at source.

But the violation is less blatant than it appears. First, the participation exemption only applies to 10% corporate shareholders. Portfolio US investors still are taxed on foreign source dividends. Moreover, when the US parent distributes a dividend to its taxable US shareholders or buys back their shares, the distribution is fully taxable at the dividend/capital gains rate of 23.8%.

Second, in conjunction with adopting the participation exemption, TCJA significantly strengthened Subpart F. Specifically, IRC section 951A now currently taxes US parents of controlled foreign corporations (CFCs) on their "global intangible low-taxed income", or GILTI, at a 10.5% rate. GILTI is defined broadly as any income that exceeds a 10% return on the CFCs' basis in their tangible assets (the "hurdle rate"), with a credit for foreign taxes. Thus, the US parents of CFCs are effectively subject to a minimum tax of 10.5% on their offshore earnings that exceeds the hurdle rate. The tax on GILTI is consistent with the single tax principle because contrary to pre-TCJA law it ensures that offshore earnings that exceed the hurdle rate are taxed at 10.5%, and that a residence-based tax applies to those earnings to the extent they are not taxed at source.

Third, there is a new anti-base erosion anti-abuse tax (BEAT) imposed at 10% on deductible payments made by US corporations to their foreign affiliates (which can be foreign parents or CFCs). The BEAT upholds the single tax principle because it imposes tax at source under circumstances where they may not be a tax at residence.

Because of these and other provisions of the TCJA, it can actually be seen as more consistent with the single tax principle than previous law. On the outbound front, prior law permitted US-based multinationals to accumulate over $3 trillion in low tax jurisdictions offshore without current US or foreign tax, which was a blatant violation of the single tax principle. On the inbound front, prior law only had a weak limit of interest deductions to foreign related parties, so that massive earnings stripping out of the US could occur.

The following sections describe first the relevant inbound provisions of TCJA and then the outbound provisions.

1. Inbound Taxation

a. The BEAT.

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The most important innovation in TCJA is the BEAT. Under new IRC section 59A, US corporate taxpayers have to pay a “base erosion anti-abuse tax” (BEAT), at 10% less any applicable credits (including the foreign tax credit, but the US taxpayer is unlikely to have them for the relevant income since any foreign tax is imposed on the foreign related party). The tax base is taxable income plus “base erosion payments”, defined as any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable, including interest (to the extent not otherwise disallowed) and, for inverted corporations, also cost of goods sold. Withholding taxes (if any) are allowed as an offset. There is a safe harbor for smaller corporations with gross receipts below $500 million and another for base erosion payments of less than 3%. The proposal applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

On its face, the BEAT does not violate tax treaties because the BEAT is applied only to the US party, so that the savings clause applies (US tax treaties Art 1(4): treaties cannot change US taxation of US residents). However, it could be construed as a violation of article 24, which is not subject to the savings clause.

However, the BEAT is not different in substance than the UK or Australian diverted profits taxes, or from the thin capitalization rules employed by most of our trading partners. Nor is it inconsistent with the EU Anti-Tax Avoidance Directive that denies a deduction if the income is not subject to tax at residence. The BEAT is an overdue response to earnings stripping out of the US, and as such is consistent with the OECD/G20 BEPS project and the single tax principle. Note, however, that the BEAT only applies to payments to related parties and can be avoided by dealing with customers or unrelated distributors.

b. Hybrid payments.

New IRC section 267A limits the deductibility of payments on hybrid instruments (treated as deductible in the US and exempt in the residence jurisdiction) or by hybrid entities (treated as corporations by the US and transparent in the residence jurisdiction, or vice versa). These provisions implement OECD BEPS Action 2 in accordance with the single tax principle.

2. **Outbound Taxation**

a. Participation Exemption.

New IRC section 245A permits an offsetting deduction of 100% for foreign source dividends received by a domestic corporation from a 10% or more owned foreign corporation. This provision is similar to the participation exemption used by most of our trading partners. It means that US corporate shareholders receiving dividends from the non-Subpart F income of CFCs will not be taxed even if that income was not subject to

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tax at source (e.g., because of a tax holiday) and was not GILTI (because it falls below the hurdle rate).

However, IRC 245A(e) disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. This is consistent with the single tax principle because income that was not taxed at source should be taxed at residence.

b. Interest Limits.

New IRC 163(j) (which replaces the old earning stripping rule) limits the deduction of net interest expense of a business to 30% of earnings before interest and taxes (EBIT). This limit is necessary to prevent tax sheltering by using borrowed funds to invest in stock of CFCs generating exempt dividends. It is directly copied from the German and UK interest limitations. However, even allowing 30% of the interest deduction can still generate negative tax rates. For example: Corporate taxpayer borrows 100 and invests in a CFC that distributes a dividend of 10. Interest payments are 10 and 3 are deductible under section 163(j). Before tax this results in a return of 10-10=0. After tax, since the dividend is exempt and 3 of interest are deductible against other income, the return is negative 3.

c. GILTI.

TCJA and new IRC sections 951A and 250 provide that a U.S. shareholder of any CFC must include in gross income for a taxable year its GILTI in a manner generally similar to inclusions of subpart F income. GILTI means, with respect to any U.S. shareholder for the shareholder's taxable year, the excess (if any) of the shareholder's net "CFC tested income" over the shareholder's "net deemed tangible income return." The shareholder's "net deemed tangible income return" is an amount equal to 10 percent of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC with respect to which it is a U.S. shareholder. "Net CFC tested income" means, with respect to any U.S. shareholder, the excess of the aggregate of its pro rata share of the tested income of each CFC over the aggregate of its pro rata share of the tested loss of each CFC. The tested income of a CFC means the excess of the gross income of the corporation determined without regard to certain exceptions (including the current active finance exception and the CFC look-through rule) over deductions (including taxes) properly allocable to such gross income. QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in the production of tested income in its trade or business and of a type with respect to which a deduction is generally allowable under section 167.

The tax rate of future GILTI is determined by taking the US tax rate (21%) and allowing a deduction of 50%, for a net rate of 10.5%. This rate can be partially offset by foreign tax credits, but in a separate basket (but with cross-averaging within the basket). The

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section is effective for taxable years of foreign corporations beginning after December 31, 2017.

What this means in plain English is that Amazon, Apple, Facebook, Google, Netflix, and their ilk will have to pay tax at 10.5% on future GILTI because they have CFCs that produce "tested income" (and no loss) in excess of 10% over their basis in offshore tangible assets, which is zero or close to it (since they derive almost all of their income from intangibles). Other MNEs (e.g., GE or Intel) will pay less because they have more tangible assets offshore. This creates an obvious incentive to move jobs (not just profits) offshore. In addition, the proposal standing on its own would also induce profit shifting because of the combination of the participation exemption and the lower rate (10.5% is less than 21%). It may also cause inversions to avoid the minimum tax on GILTI.

d. FDII.

To address the problem of shifting income from the US to CFCs, new IRC section 250 applies a reduced 13.125% to "foreign derived intangible income" (FDII) which is defined as the amount which bears the same ratio to the corporation's "deemed intangible income" as its "foreign- derived deduction eligible income" bears to its "deduction eligible income."

Deemed intangible income is the excess of a domestic corporation's deduction eligible income (gross income without regard to subpart F income, GILTI, and other enumerated categories) over its deemed tangible income return (10% of its QBAI).
The "foreign-derived deduction eligible income" is defined as income derived in connection with (1) property that is sold by the taxpayer to any foreign person for a foreign use or (2) services to any foreign person or with respect to foreign property. In other words, this category comprises exports for property and services, including royalties from the licensing of intangibles.

Deduction eligible income is essentially the domestic corporation's modified gross income calculated without regard to subpart F and GILTI (as well as a few other enumerated categories). So a U.S. company's foreign derived intangible income, which gets the 13.125% rate, is the amount that bears the same ratio to the deemed intangible income as the U.S. company's exports bear to its modified gross income.

e. Foreign Tax Credits.

The TCJA abolishes the indirect credit (IRC section 902) and limits the availability of the direct credit (IRC section 901) on dividends that qualify for the participation exemption. However, indirect credits under IRC section 960 are retained for GILTI, except that only 80% of the foreign tax may be credited. This is result in a full offset of the 10.5% minimum tax on GILTI if the foreign rate is 13.125%%.

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In addition, cross crediting is permitted, which creates an incentive to invest in high tax foreign jurisdictions. Assume a US taxpayer with 100 income from a low tax foreign jurisdiction that exceeds the GILTI hurdle rate. If the taxpayer derives another 100 from the US, it will pay 21 on the US income and 10.5 on GILTI for a total of 31.5. But if it earns 100 from a foreign jurisdiction with a tax rate of 26.25, then it will only pay 26.25 because it will have foreign tax credits of 26.25x80%=21 to eliminate its US tax on GILTI (10.5%x200).

3. THE TCJA and BEPS 1

From 2013 to 2015, the US participated in BEPS1. However, the general view in the US is that following the conclusion of the BEPS negotiations and the change of Administration in 2017, the US stepped back from the BEPS process. While the EU was charging ahead with implementing BEPS through the Anti-Tax Avoidance Directive (ATAD), the US stated that it was already in compliance with all BEPS minimum standards and therefore other than Country by Country (CBC) reporting it had no further BEPS obligations. The US refused to join the Multilateral Instrument (MLI) to implement BEPS into tax treaties, and did not join the common reporting standards (CRS) to further automatic exchange of information, leading the EU to call it a tax haven. The US did adopt BEPS provisions in its model tax treaty, but those have not been implemented in any actual US treaty. Thus, most observers believe that the US has abandoned the BEPS effort.

But this view is wrong. TCJA clearly relies on BEPS principles and in particular on the single tax principle. This represents a triumph for the G20/OECD and is incongruent with the generally held view that the US will never adopt BEPS. This can be seen in both the outbound and inbound provisions of the TCJA.

For outbound transactions, GILTI means that Amazon, Apple, Facebook, Google, Netflix, and their ilk will have to pay tax at 10.5% on future GILTI because they have CFCs that produce “tested income” (and no loss) in excess of 10% over their basis in offshore tangible assets, which is zero or close to it (since they derive almost all of their income from intangibles). This imposes residence taxation in cases where there is no or low taxation at source. For inbound transactions, the BEAT means that a minimum tax of 10% will apply to many payments to foreign related parties. This imposes source taxation where there may not be taxation at residence.

TCJA also contains two anti-hybrid provisions that directly implement the single tax principle, similarly to the ATAD. The first, IRC 245A(e), disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. The second, IRC section 267A, limits the deductibility of payments on hybrid instruments or to hybrid entities. These provisions clearly implement OECD BEPS Action 2 in accordance with the single tax principle.

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Overall, The TCJA contains multiple provisions that incorporate the principles of the OECD/G20 Base Erosion and Profit Shifting (BEPS) into domestic US tax law. Together with the changes in the 2016 model US tax treaty, these provisions mean that the US is following the EU and China in implementing BEPS and in particular its underlying principle, the single tax principle (i.e., all income should be subject to tax once: passive income at the residence state rate and active income at a minimum source tax rate). This represents a triumph for the G20/OECD and is incongruent with the generally held view that the US will never adopt BEPS.

5. Conclusion: BEPS 2, 2018-

As developed by the OECD, BEPS 2 has two pillars. Pillar 1 is the extension of BEPS 1 action 1, dealing with the digital economy. It is still in process but what has been revealed so far envisages far reaching changes to the international tax regime, primarily by partially abandoning the arm's length principle (ALP) and the permanent establishment threshold (PE). Neither of these changes are driven by the US, and it remains to be seen whether they will succeed in averting the widespread adoption of digital services taxes (DSTs) intended to impose some tax burden on US MNEs.

Pillar 2, on the other hand, is a direct extension of the TCJA. The GLOBE proposal builds on GILTI and BEAT in implementing the single tax principle by (a) requiring residence taxation at a minimum rate if the source country does not impose tax and (b) denying deductions at source if the residence country does not tax.

Both Pillar 2 proposals represent an improvement over the TCJA. The residence based proposal is an improvement over GILTI if it denies cross crediting, which fosters tax competition. The source based proposal is an improvement over BEAT because it explicitly links the denial of deductions to whether the income is taxed at residence, which the BEAT does not do.

Thus, the current state of affairs can be characterized as a constructive dialogue: The OECD moves (BEPS 1), the US responds (TCJA), the OECD moves again (BEPS 2). Hopefully BEPS 2 will succeed and the US will then go along and amend the TCJA as well as adopt the changes envisaged in pillar 1. From this kind of dialectic, a new international tax regime fit for the 21st century may emerge.

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