BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?

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Combating Tax Avoidance in the EU
Harmonization and Cooperation in Direct Taxation

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CHAPTER 1

BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?

Reuven Avi-Yonah & Gianluca Mazzoni

The Tax Cuts and Jobs Act (TRA17) signed into law by President Trump on 22 December 2017 contains multiple provisions that incorporate the principles of the OECD/G20 Base Erosion and Profit Shifting Action Plan (BEPS) into domestic US tax law. Together with the changes in the 2016 US Model Tax Treaty, these provisions mean that the United States is following the European Union in implementing BEPS and particularly its underlying principle, the single tax principle (all income should be subject to tax once at the rate derived from the benefits principle, i.e., active income at a minimum source tax rate and passive at the residence state rate). This represents a

1. On 17 Feb. 2016 the Treasury Department issued a newly revised US Model Income Tax Convention, which includes several measures consistent with the single tax principle, e.g., Art. 1(8), a revised version of the so-called 'triangular permanent establishment' rule that has been included in some of the US income treaties since the 1990s, such as those with Austria Art. 16(4), Belgium Art. 21(6), Denmark Art. 22(6), Finland Art. 16(5), France Art. 30(5), Germany Art. 28(5), Iceland Art. 21(5), Ireland Art. 23(7), Luxembourg Art. 24(5), Malta Art. 22(5), the Netherlands Arts 1 and 2 of 1993 Protocol, South Africa Art. 22(6), Sweden Art. 17(5), and Switzerland Art. 22(4); new language added to Arts 10(5), 11(2)(d), 12(2)(b) and 21(2)(b) 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; a newly defined term 'special tax regime' used in Arts 11(2)(c), 12(2)(a) and 21(2)(a) that would prevent reduction of withholding taxes for deductible related-party payments when the beneficial owner of the payment pays little or no tax on the related income; significant changes to Art. 22 in order to make treaty access more difficult than under the 2006 Convention. On BEPS and the US Model, see R.S. Avi-Yonah, Full Circle? The Single Tax Principle, BEPS, and the New US Model (13 Oct. 2015), U of Michigan Public Law Research Paper No. 480, 1 Global Tax'n 12 (2016); U of Michigan Public Law Research Paper No. 480; U of Michigan Law & Econ Research Paper No. 15-019. Available at SSRN: https://ssrn.com/abstract=2673463 or http://dx.doi.org/10.2139/ssrn.2673463 (accessed 5 Apr. 2018). See also M. Herzfeld, US Perspectives on the Multilateral Instrument, 46 Intertax 1, pp. 80 et seq. (2018).
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triumph for the G20/OECD and is incongruent with the generally held view that the United States will never adopt BEPS.

§1.01 INTRODUCTION: THE US AND BEPS

Since its launch in 2013, the United States has actively participated in all aspects of the BEPS Project. However, until recently, the general view was that following the conclusion of the BEPS negotiations and the change of Administration, the United States was stepping back from the BEPS process. While the European Union was charging ahead with implementing BEPS measures through the Anti-Tax Avoidance Directive (ATAD), the United States stated that it was already in compliance with all BEPS minimum standards and therefore other than country-by-country reporting (CbCR) it had no further BEPS obligations. The United States decided not to sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which would have obliged it to implement BEPS into tax treaties and did not join the Common Reporting Standard (CRS) to further automatic exchange of information, leading the European Union to call it a tax haven.

2. Early commentators argued that the OECD has good reason to be pessimistic about the BEPS Project’s success under the new US administration, primarily due to the lack of enthusiasm showed by previous Republican administrations in prioritizing the fight against international tax avoidance and evasion, such as the Bush Administration’s position on the OECD harmful tax practices project and Trump’s ideological roots. See T. Fensby, Will the BEPS Project Survive the Trump Administration? (DOC 2017-50984) 86 Tax Notes Int’l (1 May 2017), p. 617. That view has been recently upheld by a panel of experts, during the EU-US Tax Relationship Forum: Contest or Dialogue seminar organized by Ludovici & Partners, according to which the path taken by the US Congress last December is inconsistent with the BEPS Project, which the United States declined to sign last June, because, as Ludovici stated, ‘the BEPS project has an anti-avoidance function, while BEAT is entirely designed and focused on the US.’ Unofficial authors’ translation of A. Galimberti, Con Beat e Giffi il fisco Usa torna indietro di 17 anni, Il Sole 24 ORE, 14 Mar. 2018.

3. According to Henry Louie, Deputy International Tax Counsel at the US Treasury Department, the United States did not sign the MLI because its tax treaty network has a low degree of exposure to BEPS issues and many of the MLI provisions are consistent with the Treasury Department’s long-standing policy, i.e., rules that determine when treaty benefits should be available for payments through fiscally transparent entities, Art. 1(6) of the 2016 Model; robust bright-line objective limitation on benefits (LOB) rules that prevent third-country investors from routing their investment into the United States through a company resident in a treaty partner to get treaty benefits. Louie has also pointed to the challenges involved with obtaining consideration by the Senate Foreign Relations Committee (first) and ratification by the Senate (after) in explaining the United States’ refusal to sign on to the MLI. See K. Bell, Treasury Official Explains Why U.S. Didn’t Sign OECD Super-Treaty, BNA Transfer Pricing Report (8 June 2017) available at https://www.bna.com/treasury-official-explains-n73014453413/ (accessed 5 Apr. 2018).


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The United States has adopted BEPS provisions in its model tax treaty⁶ but they have not been implemented in any actual US treaty.⁷ Thus, most observers believe that the United States has abandoned the BEPS effort.

This view is not wholly correct. The current tax reform legislation clearly relies on BEPS principles and particularly on the single tax principle. This represents a triumph for the G20/OECD and challenges the generally held view that the United States will never adopt BEPS.

This chapter proceeds in four parts. Sections 1.02, 1.03 and 1.04. analyse the three BEPS provisions included in TRA17: a one-time ‘transition tax’ on untaxed accumulated earnings and profits (E&P) of certain non-US corporations (new § 965) and two anti-base erosion and income shifting provisions, namely a foreign minimum tax on 10% US shareholders of controlled foreign corporations (CFCs) to the extent the CFCs are treated as having ‘global intangible low-taxed income’ (GILTI) (new § 951A) and a base erosion and anti-abuse tax (BEAT) that will be imposed in relation to deductible payments made by certain corporations to their non-US affiliates (new § 59A). Section 1.05 discusses one of the key BEPS Action items that caused the most concern in the United States, i.e., Action 6 on the prevention of treaty abuse through inclusion of a principal purpose test (PPT). In section 1.06, the authors argue that Congress could have done more, especially with regard to the anti-hybrid rules for certain related-party amounts of the new § 267A since it does not have any significant

⁶ Treasury Department and Internal Revenue Service (IRS) have issued final regulations that treat a domestic disregarded entity wholly owned by a foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting, record maintenance and associated compliance requirements that apply to 25% foreign-owned domestic corporations under s. 6038A of the Internal Revenue Code (IRC). In the authors’ opinion re AEol, this should give the United States something to exchange.

⁷ Supra n. 1. In addition to these new provisions, the 2016 Model incorporates certain other BEPS recommendations for the first time: (i) a new preamble language that makes clear that the parties’ common intention with the treaty is to eliminate double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements; (ii) a rule intended to prevent contract-splitting to circumvent the twelve-month threshold for building sites or construction or installation projects (Art. 5(3)) and (iii) a twelve-month ownership and residence requirement for the 5% withholding rate for direct dividends (Art. 10(2)). Finally, the 2016 Model has not adopted the Final Report on Action 7 proposed amendments to Art. 5(5) and (6) of the OECD Model Tax Convention that address the application of the so-called ‘dependent agent PE’ provisions to commissionaire arrangements and similar strategies, as well as those to Art. 5(4) that would have narrowed the specific activity exceptions. The reason is that the United States has not seen promised guidance on attribution of profits to permanent establishments (PEs) and is not confident about how its treaty partners intend to apply those rules. See M. Herzfeld, New Analysis: The Multilateral Instrument and Permanent Establishments, 86 Tax Notes Int’l (19 June 2017), pp. 1029 et seq.

impact on foreign-to-foreign hybrid planning. To this extent, it should be noted that in order to limit the application of Subpart F exceptions to transactions that use reverse hybrids to create stateless income, the Obama Administration proposed a rule that would provide that § 954(c) and 954(c)(6) do not apply to payments made to a foreign reverse hybrid held directly by a US owner when those amounts are treated as deductible payments received from foreign related persons. Section 1.07 provides some conclusions.

§1.02 PAST ACCUMULATIONS

Section 965 of TRA17 provides for a one-time deemed repatriation tax on previously untaxed accumulated foreign earnings. TRA17 splits E&P between cash and illiquid assets with cash amounts taxed at a 15.5% effective rate and illiquid assets taxed at an 8% effective rate. The taxpayer may elect to pay this tax over an eight-year period. However, if a US shareholder becomes an 'expatriated entity' within the meaning of § 7874(a)(2) at any point within the ten-year period following enactment of TRA17, the benefits of the reduced rates would be recaptured. In that event, the US shareholder would be subject to an additional tax equal to 35% of the amount of the deduction allowed in respect of the transition tax. No foreign tax credits are permitted to offset this additional tax.

The accumulation of offshore profits by US multinationals in low-tax jurisdictions has been the focus of significant concern and a primary driver of the BEPS effort. The EU ATAD and State aid as well as the UK diverted profits tax (DPT) and current discussion on the digital economy all reflect these concerns. Indeed, these earnings, accumulated since the 2004-2005 tax amnesty and currently exceeding USD 2.6 trillion, are located in just seven low-tax jurisdictions and they are highly

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8. Fourteen per cent in the House bill § 4004 and 14.5% in the Senate amendment § 14103.
9. Seven per cent in the House bill § 4004 and 7.5% in the Senate amendment § 14103.
10. Section 965(h)(1).
11. A foreign corporation or publicly traded foreign partnership (foreign acquirer) acquires a US corporation (domestic target) and former shareholders of the US corporation hold at least 60% (by vote or value) but less than 80% of the stock of the combined entity. See O. Marian, Home Country Effects of Corporate Inversions, 90 Wash. L. Rev. 1, 7–9 (2015).
12. Section 965(l)(1).
concentrated: just four companies (Apple, Microsoft, Pfizer and GE) hold approximately one quarter (24%) of the offshore profits. Ten companies have 38% of the profits and fifty companies hold three quarters of the earnings.

In the authors' opinion, there are four arguments for why such low rates are inappropriate for past earnings. First, as a policy matter, there is no justification for not taxing these profits in full, because they do not raise competitiveness issues (since they have been earned) or behavioural response issues (since the behaviour has already

15. Apple Inc. 2017 Form 10-K at p. 30: ‘As of September 30, 2017 and September 24, 2016, the Company’s cash, cash equivalents and marketable securities held by foreign subsidiaries were $252.3 billion and $216.0 billion, respectively, and generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.’, http://files.shareholder.com/downloads/AAPL/6134806168x0xS320193-17-70/320193/filing.pdf (accessed 5 Apr. 2018).

16. Microsoft Corp 2017 Form 10-K: ‘Of the cash, cash equivalents, and short-term investments as of June 30, 2017, $127.9 billion was held by our foreign subsidiaries and would be subject to material repatriation tax effects. The amount of cash, cash equivalents, and short-term investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was $2.4 billion. As of June 30, 2017, approximately 87% of the cash equivalents and short-term investments held by our foreign subsidiaries were in U.S. government and agency securities, approximately 3% were invested in U.S. mortgage- and asset-backed securities, and approximately 2% were invested in corporate notes and bonds of U.S. companies, all of which are denominated in U.S. dollars. The remaining cash equivalents and short-term investments held by our foreign subsidiaries were primarily invested in foreign securities’, https://www.microsoft.com/investor/reports/ar17/index.html# (accessed 5 Apr. 2018).

17. Pfizer Inc. 2016 Form 10-K at p. 95: ‘As of December 31, 2016, we have not made a U.S. tax provision on approximately $86.0 billion of unremitted earnings of our international subsidiaries. As these earnings are intended to be indefinitely reinvested overseas, the determination of a hypothetical unrecognized deferred tax liability as of December 31, 2016 is not practicable’, http://d18m0p25wr6d.cloudfront.net/CIK-0000078003/3e486f49-627a-4c2c-b133-0e7d714465a4.pdf (accessed 5 Apr. 2018). In its 2017 Financial Report, Pfizer stated that, ‘Given the recent changes in tax law under the TCJA, which includes transitioning U.S. international taxation from a worldwide tax system to a territorial tax system, we have recorded a repatriation tax [[$15.2 billion tax liability] on deemed repatriated accumulated post-1986 earnings of foreign subsidiaries for which we plan to elect payment over eight years through 2026 [first instalment due in April 2019].’ See 2017 Financial Report at p. 57, https://s2l.q4cdn.com/317678438/files/doc_financials/Annual/2017/Financial-Report-2017.pdf (accessed 5 Apr. 2018).

18. GE 2016 FORM 10-K at p. 93: ‘At December 31, 2016 and 2015, approximately $82 and $104 billion of earnings, respectively, have been indefinitely reinvested outside the United States. Most of these earnings have been reinvested in active non-US business operations, and we do not intend to repatriate these earnings to fund U.S. operations. Because of the availability of U.S. foreign tax credits, it is not practicable to determine the U.S. federal income tax liability that would be payable if such earnings were not reinvested indefinitely outside the United States’, https://www.ge.com/ar2016/assets/pdf/GE_AR16.pdf (accessed 5 Apr. 2018). In its 2017 FORM 10-K, GE stated that, ‘On December 22, 2017, the U.S. enacted the Tax Cuts and Jobs Act (U.S. tax reform) that lowers the statutory tax rate on U.S. earnings, taxes historic foreign earnings at a reduced rate of tax, establishes a territorial tax system and enacts new taxes associated with global operations. As a result of the enactment of U.S. tax reform, we have recorded tax expense of $3.3 billion in 2017 to reflect our provisional estimate of both the transition tax on historic foreign earnings ($1.2 billion) and the revaluation of deferred taxes ($2.2 billion)’, https://www.sec.gov/Archives/edgar/data/40545/000004054518000014/ge10-k2017.htm at p. 21 (accessed 5 Apr. 2018).
happened) and because they mostly represent earnings on intellectual property developed in the United States with hefty taxpayer support.\(^\text{19}\)

Second, there are a few outstanding issues with dual rates, including: (i) what may be considered a ‘cash or cash equivalent’ for the purposes of this tax and (ii) whether there would be a look-back rule for ‘cash or cash equivalent’ assets recently invested to take advantage of the lower rate, or a more general anti-abuse rule targeting transactions carried out to achieve the lower rate. The reason is simple: taxpayers are incentivized to manipulate their foreign cash positions by converting cash to more illiquid investments and by legitimately distributing some of their cash through dividend payments or other means.\(^\text{20}\) The new law includes both a look-back rule and a subjective intent-based anti-abuse test, the PPT. Indeed, § 965(c)(3)(A) provides a formula for calculating how much E&P should be attributed to cash assets and therefore subject to the higher 15.5% rate. The benchmark is the ‘aggregate foreign cash position’ calculated as the greater of either ‘the pro rata share of the cash position of all specified foreign corporations as of the last day of the last taxable year beginning before January 1, 2018, or the average of the cash position determined on the last day of each of the two taxable years ending immediately before November 2, 2017.’ In addition, § 965(c)(3)(F) states that, ‘If the Secretary determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account under this subsection, such transaction shall be disregarded for purposes of this subsection [emphasis added].’ The Conference Report accompanying TRA17, states that, ‘The provision also authorizes the Secretary to disregard transactions that are determined to have the principal purpose of reducing the aggregate foreign cash position [emphasis added],’ thus, viewing those two formulations as having the same meaning. But if ‘a principal purpose’ shall be defined as being one of its ‘first-in importance’ purposes, the authors believe that the effectiveness of § 965(c)(3)(F) would be substantially undermined. In this regard, the extensive report prepared by the Tax Section of the New York State Bar Association (NYSBA) on the 1994 proposed partnership anti-abuse regulation stated:

If a transaction were subject to attack only if the’ principal purpose were tax avoidance, the result would be a substantially increased willingness on the part of taxpayers to engage in aggressive transactions. In our experience, a taxpayer usually is able to assert some nontax purpose for a transaction, even if that purpose is on its face borderline. \textit{Any such claim would have to satisfy a much lower}

\(^{19}\) According to the Permanent Subcommittee on Investigations (PSI) report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.), in 2011, almost all of Apple’s research activity was conducted by Apple Inc. employees in California. The vast majority of Apple’s engineers, product design specialists and technical experts were physically located in California.

threshold of ‘believability’ if the test were whether ‘the’ principal purpose of the transaction is tax avoidance … The history of § 269, the corporate anti-abuse rule that applies only when ‘the’ principal purpose of a transaction is tax avoidance, demonstrates the weakness of such a test. The Service has been unable to successfully apply § 269 with any regularity, as indicated by the dearth of judicial decisions under that section as well as our experience that agents in the field rarely attempt to apply the section. We believe those results may be attributable to § 269’s requirement that ‘the’ principal purpose of a transaction be tax avoidance, which often allows the taxpayer to prevail by asserting a relatively weak business purpose [emphasis added].21

Third, studies have highlighted that repatriated earnings in 2004 were used to send cash back to shareholders, either in the form of dividends or stock buybacks,22 instead of being invested in new US jobs and infrastructure as President Trump sold TRA17 on the promise that, ‘the plan is going to bring trillions of dollars back into the United States, money that’s offshore … But you look at the great companies – Apple and so many others. They have billions of dollars overseas that they want to bring back. Now they’re going to be able to bring it back, and we’ll [sic] spending that money, and they’ll be spending that money right here. And it will be jobs and lots of other good things [emphasis added].’23 Thus, it is highly likely that repatriated funds will be used for already planned projects, such as pay down [sic] existing borrowings,24 set off a new wave of M&A,25 rather than being invested in expansion. For example, Cisco expects to spend much of the newly repatriated cash on share buybacks and dividends over the next two years.26 On the other hand, Apple announced in January that it would invest USD 30 billion in capital spending in the United States; over five years that would

22. K.A. Clausing, Profit shifting and U.S. corporate tax policy reform, Washington Center for Equitable Growth (May 2016), at p. 10: ‘As part of the American Jobs Creation Act of 2004, the U.S. government gave U.S. multinational firms a temporary holiday for repatriating income at a low rate of 5.25 percent. This holiday dramatically increased repatriations, but the inflow of funds was largely used for share repurchases and dividend issues, and did not boost employment or investment despite the hopeful title of the legislation [emphasis added],’ http://cdn.equitablegrowth.org/wp-content/uploads/2016/05/05115111/051016-clausing-profit-shifting.pdf (accessed 5 Apr. 2018).
25. C. Nao, Trump’s Corporate Tax Reform Pooled to Fuel More M&A, Law 360 (28 Apr. 2017): ‘We would expect to see an increase in domestic acquisitions by U.S. multinationals. They would have access to their cash that has been trapped overseas, so repatriation tax or deemed repatriation tax at a rate that is below 35 percent would allow companies, instead of having to borrow, to access that cash to make domestic acquisitions . . .’, https://www.law360.com/tax/articles/918368/trumps-corporate-tax-reform-pooled-to-fuel-more-m-a (accessed 5 Apr. 2018).
create more than 20,000 jobs. However, analysts questioned whether Apple’s commitments were new and impacted in any way by the tax reform since the company would have been able to make this investment with existing cash flow – without needing to tap into cash holdings.27

Last but not least, this money is not trapped offshore. Under the previous § 956(c)(2)(A) and (F), a foreign subsidiary’s untaxed earnings might have been invested without triggering the deemed dividend rules regarding stock of a domestic corporation, a debt obligation of a US person or a US bank deposit, as long as the issuer was not a US shareholder or did not have a 25% or other proscribed relationship with the foreign subsidiary.28 The US Senate Permanent Subcommittee on Investigations on the 2004 tax holiday has showed that at the end of FY2010, of the USD 538 billion in undistributed accumulated foreign earnings of twenty US multinational corporations, nearly half (46%) of the funds that the corporations had identified as offshore and for which US taxes had been deferred were actually deposited in the names of CFCs in accounts at US financial institutions.29 Recent data compiled by Bloomberg shows that the top ten US multinationals have boosted their investments in government bonds to USD 113 billion from USD 67 billion and have received at least USD 1.4 billion in interest payments over the past five years.30

§1.03 FUTURE ACCUMULATIONS

In TRA17, the shift from a worldwide system of taxation to a quasi-territorial one is accompanied by some sort of a foreign minimum tax, the so-called global intangible low-taxed income (GILTI) provision, the stick. The intent is to discourage erosion of the US base by moving or holding intangible assets outside the United States. Under the new § 951A(a), a US shareholder of any CFC must include in its gross income for a taxable year its GILTI in a manner generally similar to inclusion of Subpart F income. GILTI means, with respect to any US 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.31 Net deemed tangible income return is, with respect to any US shareholder for a taxable year, the excess (if any) of 10% of the aggregate of its pro rata share of the qualified business asset investment (QBAI) of each CFC with respect to which it is a US shareholder over the amount of interest expense taken into account in determining its net CFC tested income for the taxable year to the extent that the interest expense exceeds the interest income properly allocable to the interest


31. Section 951A(b)(1).
expense that is taken into account in determining its net CFC tested income.\textsuperscript{32} Net CFC tested income means, with respect to any US shareholder, the excess of the aggregate of the shareholder’s pro rata share of the tested income of each CFC with respect to which it is a US shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a US shareholder.\textsuperscript{33} The tested income of a CFC means the excess (if any) of the gross income of the corporation – determined without regard to certain exceptions to tested income – over deductions (including taxes) properly allocable to such gross income.\textsuperscript{34} 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 its trade or business and of a type with respect to which a deduction is generally allowable under § 167.\textsuperscript{35} To put it simply, the formula for GILTI can be expressed as:

\[
\text{GILTI} = \text{Net CFC Tested Income} - [(10\% \times \text{QBAI}) - \text{Interest Expense}]
\]

As a result, the formula generally exempts from inclusion a deemed return on tangible assets and assumes the residual income to be intangible income that is subject to current US tax.\textsuperscript{36}

The tax rate for future GILTI is determined by taking the 21\% corporate tax rate and allowing a deduction of 50\%,\textsuperscript{37} to give a net rate of

\textsuperscript{32} Section 951A(b)(2).
\textsuperscript{33} Section 951A(c)(1).
\textsuperscript{34} Section 951A(c)(2).
\textsuperscript{35} Section 951A(d)(1).
\textsuperscript{36} M.A. Sullivan, \textit{Economic Analysis: More Gilti Than You Thought}, 89 Tax Notes Int’l (12 Feb. 2018), p. 587: ‘GILTI is an arbitrary measure of high profitability. \textit{High profits} (relative to tangible assets) \textit{could be related to the presence of intangibles}, as economists often assume, or may have nothing to do with intangibles at all. Drafters did the public no favors with the GILTI acronym. The “I” in GILTI is understandably confusing to many because \textit{there is otherwise no direct reference to intangible assets in the statutory text}, and these assets play no direct role in the calculation of tax liability under sections 951A and 250. And, as we shall see, the “L” is also misleading because in certain circumstances, GILTI can be subject to U.S. tax even when the average worldwide foreign tax rate of a U.S. taxpayer is not low;’ C.H. Lowell, M.P. Thomas & K.L. Novak, \textit{The International Provisions of the TCJA, Corporate Taxation} (WG&L) (Mar./Apr. 2018): ‘In general, the new GILTI provision is designed to impose a minimum residual U.S. tax on above-routine CFC earnings, with the exempt routine return being defined generally as a 10\% return on the CFC’s tangible property (“qualified business asset investment,” or “QBAI”).’
\textsuperscript{37} Section 250(a)(1)(B) For taxable years beginning after 31 Dec. 2025, the deduction for GILTI is lowered to 37.5\%, see § 250(a)(3)(B). It should be noted that the conference agreement followed § 14202 of the Senate amendment, clarifying that the deduction for GILTI is only available to domestic corporations, i.e., C corporations that are not RICs or REITs. US shareholders that are not domestic corporations are subject to full US tax on their GILTI. An S corporation’s taxable income is computed in the same manner as individual (§ 1363(b)) so that deductions allowable only to corporations, such as FDII and GILTI, do not apply. See Conference Report to TRA17, n.
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 provision is effective for taxable years of foreign corporations beginning after 31 December 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 bases in offshore tangible assets, which will be 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 this regard, a Baker McKenzie Client Alert observed that, ‘the GILTI rules create a surprising and unexpected incentive for U.S. multinationals to increase the amount of tangible assets held by their CFCs, which in most circumstances will presumably be situated outside the United States. Assuming a more or less steady amount of overall income potentially subject to section 951A (and deductible under section 250), increasing QBAI held by CFCs may be one of the most effective ways to manage or reduce GILTI.’

To address these issues, TRA 17 proposes two solutions. First, § 951A(d)(4) includes a very broad anti-abuse provision which reads as follows: ‘[f]or purposes of determining QBAI, the Secretary is authorized to issue anti-avoidance regulations or other guidance as the Secretary determines appropriate, including regulations or other guidance that provide for the treatment of property if the property is transferred or held temporarily, or if avoidance was a factor in the transfer or holding of the property [emphasis added].’ Second, § 250(a)(1)(A) provides a 37.5% foreign-derived intangible income deduction (FDII), the carrot, with the result that the portion of a US
corporation’s intangible income derived from serving foreign markets is effectively taxed at 13.125%. The intent is to encourage US multinationals to remain in the country and keep their assets, earnings, jobs and functions there.

Section 250(b)(1) defines the FDII of any domestic corporation 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’. In other words, a domestic corporation’s FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign derived.

Deemed intangible income is the excess of a domestic corporation’s deduction eligible income over its deemed tangible income.\(^{44}\)

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 provided to any foreign person, or with respect to foreign property.\(^{46}\) Foreign use means any use, consumption or disposition which is not within the United States.\(^{47}\) For purposes of the provision, the terms ‘sold,’ ‘sells,’ and ‘sale’ include any lease, exchange or other disposition. Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or related parties. Section 250(b)(5)(B) and (b)(5)(C) operate to make sure that property is ultimately sold to a foreign person for use or consumption abroad or services are provided to a person, or with respect to property, located outside the United States. If property is sold to a related foreign party, the sale is not treated as for a foreign use unless the property is sold by the related foreign party to another person who is unrelated and is not a US person and the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use.\(^{48}\) Transactions implicating this rule might arise where, for example, a US corporate taxpayer who owns intellectual property (IP) rights domestically in film or television programming licenses those rights to a wholly owned foreign subsidiary, which, in turn, sub-licenses the content in its local market to third parties.\(^{49}\) A similar restriction also exists with services provided to a related party located outside the United States. Income derived from such a transaction does not qualify as foreign-derived deduction eligible income unless the

\(^{44}\) Section 250(b)(3)(A) Gross income without regard to certain exceptions – (1) subpart F income; (2) GILTI; (3) financial services income; (4) dividends received from a related person; (5) domestic oil and gas extraction income; and (6) foreign branch income – over deductions (including taxes) properly allocable to such gross income.

\(^{45}\) Section 250(b)(2)(B) 10% of the corporation’s QBAI; Baker McKenzie, supra n. 42, at p. 20: 'Second, as a planning matter, we note that the key components of the formula – specifically, those over which the taxpayer might be able to exercise some degree of control, – are “deemed intangible income” and “foreign derived deduction eligible income”. Broadly speaking, any increase in such amounts will result in an increase in the deduction under Section 250 ... Consequently a reduction in a domestic corporation’s QBAI will tend to increase deemed intangible income and, accordingly, FDII [emphasis added].'

\(^{46}\) Section 250(b)(4).

\(^{47}\) Section 250(b)(5)(A).

\(^{48}\) Section 250(b)(5)(C)(i).

taxpayer establishes to the satisfaction of the Secretary that the service is not substantially similar to services provided by the related party to persons located within the United States.  

There are three obvious problems with the FDII deduction.

According to a group of thirteen tax law professors, taxpayers may be able to take advantage of the reduced rate on export income through ‘resale’ transactions where goods are sold to independent foreign distributors who subsequently resell back into the United States. In their opinion, Treasury should address such ‘roundtripping’ transactions in regulations with rules similar to those under Treas. Reg. 1.954-3(a)(3)(ii), 51 which determine the place of use, consumption or disposition of property for the purposes of sales income of foreign based companies. In particular, Treasury should require US manufacturers to conduct a real investigation of how much the independent foreign party will sell back into the United States. 52 Another major issue that Treasury should focus on is the level of further processing required to qualify as foreign use. Assuming that roundtripping transactions are permitted to the extent that the property sold is to some extent further processed abroad, 53 what would be the minimum amount of further processing necessary to allow reimportation into the United States? In the authors’ opinion, Treasury should apply standards similar to the ‘substantial transformation’ and/or ‘substantial contribution’ tests provided by Treas. Reg. 1.954-3(a)(4)(ii) and 1.954-3(a)(4)(iv). If substantial transformation and/or contribution may sound like high standards, the authors believe that property should be, at least, significantly or materially modified before being reimported into the United States. Additional guidance will be needed for computer software transactions where software is licensed to be merely imprinted in physical CDs and then sold back into the United States. In the authors’ opinion, income derived from such a transaction should

50. Section 250(b)(5)(C)(ii).
51. Treas. Reg. § 1.954-3(a)(ii): ‘As a general rule, personal property which is sold to an unrelated person will be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized [emphasis added].’
53. Conference Report to TRA17: ‘If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use’, n. 1522 at p. 625. For a comment, see Kamin et al., *supra* n. 52, at p. 20: ‘This presumably allows for roundtripping so long as there is some degree of foreign processing since otherwise this rule would not be necessary. It is possible that, by negative implication, the conferees aimed to imply that a sale for reimportation would not be for foreign use in the absence of further foreign processing.’
not qualify as foreign-derived deduction eligible income since the software is merely imprinted in physical form and not significantly modified.

Second, the authors believe that the FDII regime is clearly inconsistent with the modified nexus approach adopted by the OECD in the BEPS because it does not require any activity to be carried out in the United States other than exporting. Taxpayers can get the lower rate by importing goods and immediately exporting them. As stated by Schier, 'the provision does not require that anything be manufactured in the U.S. The formula is based only on profits from exports. A U.S. corporation could buy goods from a related or unrelated foreign supplier, resell them around the world, and have FDII for its profits on foreign sales. Not a single employee need be in the United States.'

Third, the FDII regime has a blatant and obvious WTO problem: it is a subsidy contingent upon export performance, which is explicitly prohibited by Article 3.1(a) of the Subsidies and Countervailing Measures Agreement (SCM). This was precisely the type of export subsidy struck down in the 'Domestic International Sales Corporation,' 'Foreign Sales Corporation' and 'Extraterritorial Income' cases, resulting in massive potential sanctions and forcing the United States to repeal the subsidy and enact a domestic manufacturing provision (§ 199) that did not violate the SCM because it was not contingent upon export performance. The FDII has a very low chance of surviving a WTO dispute not only because it clearly satisfies the definition of a 'prohibited subsidy' under the SCM agreement, but also because it is inconsistent with the main arguments advanced by the United States during the US-FSC litigation. The authors would expect that this provision will be struck down by the WTO and the United States will be left with only the GILTI provision. As stated above, the GILTI provision is inadequate but this can be fixed by a future Democratic administration by the setting of the GILTI rate as the same as the domestic rate (21%).

54. In addition, in their letter sent to Treasury Secretary Mnuchin, the Finance Ministers of France, Germany, Italy, Spain and the United Kingdom noted that: 'The design of the regime is notably different from accepted IP regimes by providing a deduction for income derived from intangible assets other than patents and copyright software, such as branding, market power, and market-related intangibles. It would not be compatible with the BEPS consensus that has been approved by more than 100 states and jurisdictions worldwide. Furthermore, in deviation of the agreed nexus approach, the proposal will provide benefits to income from IP assets that are in no direct connection with R & D activity [emphasis added].'


57. In this regard, it should be noted that on 1 March Rep. Rosa L. DeLauro (D-Conn.) has introduced legislation (H.R. 5145) to amend the IRC of 1986 'to eliminate tax preferences for foreign profits by repealing the reduced rate of tax on foreign-derived intangible income and global intangible low-taxed income' See Rep. DeLauro Introduces Bill to Eliminate Tax Preferences for Foreign Profits, Targeted News Service (3 Mar. 2018).
§1.04 BASE EROSION

The Conference Agreement followed the Senate’s BEAT with some changes, an alternative to the House excise tax proposal. Under the new § 59A(a), an ‘applicable taxpayer’ is required to pay a tax equal to the ‘base erosion minimum tax amount’ for the taxable year. The BEAT generally applies to corporations (other than RICs, REITs or S corporations) that over a three-year period have average annual gross receipts of at least USD 500 million and a ‘base erosion percentage’ for the taxable year of at least 3%. The ‘base erosion minimum tax amount’ is the excess of 10% of the taxpayer’s ‘modified taxable income’ over the taxpayer’s ‘regular tax liability’ (defined in § 26(b)) reduced (but not below zero) by the excess (if any) of credits allowed against such regular tax liability over the sum of: (1) § 38 credit properly allocable to the § 41(a) research credit; plus (2) the portion of the applicable § 38 credits not in excess of 80% of the lesser of such credits or the base erosion minimum tax amount.

To determine its modified taxable income, a corporation computes its taxable income for the year without regard to any ‘base erosion tax benefit’ with respect to any ‘base erosion payment’ or the ‘base erosion percentage’ of any allowable net operating loss deduction allowed under section 172 for the taxable year. A ‘base erosion payment’ is defined as any amount paid or accrued to a foreign related person that is a related party of the taxpayer and with respect to which a deduction is allowable, including interest and royalties; amounts paid in connection with an acquisition of property subject to the allowance of depreciation (or amortization in lieu of depreciation); premiums or other consideration paid or accrued for any reinsurance payments and, for inverted corporations only, also the cost of goods sold (COGS).

On the other hand, payments for services if such services qualify for the services cost method under Treas. Reg. § 1.482-9 and only if they are made for services that have no markup component,
as well as any qualified derivative payment, are not treated as base erosion payments.\textsuperscript{68}

A couple of preliminary observations are in order. First, the real purpose of BEAT seems to be somehow ambiguous and confounding. If BEAT intends to prevent the erosion of and protect the US tax base, why does it make a distinction between payments to foreign related parties and payments to unrelated ones and include only the former in calculating the new tax? Stevens and Barnes argue that the definition of base erosion payment apparently reflects the US government’s lack of confidence in policing transfer pricing.\textsuperscript{69} In this regard, it should be noted that § 59A(i) provides that the Secretary of the Treasury is to prescribe such regulations or other guidance necessary or appropriate, including regulations providing for such adjustments to the application of this section necessary to prevent avoidance of the provision, including through: (1) the use of unrelated persons, conduit transactions or other intermediaries or (2) transactions or arrangements designed in whole or in part: (A) to characterize payments otherwise subject to this provision as payments not subject to this provision or (B) to substitute payments not subject to this provision for payments otherwise subject to this provision. In the authors’ opinion, principles similar to those under the anti-conduit regulations\textsuperscript{70} may be applied to identify whether a foreign related party is the actual beneficial owner of a base erosion payment.

Second, it offers tax planning opportunities with unintended consequences. Rather than manufacturing the goods itself and paying the foreign affiliate a royalty for the use of software, trademark or other intellectual property, a US corporation may prefer to purchase the finished products from a foreign affiliate. The fact that a royalty payment is excluded from a US company’s COGS but included in the expanded tax base creates incentives to move jobs offshore.\textsuperscript{71}

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\textsuperscript{68} Section 59A(h)(1).


\textsuperscript{70} Treas. Reg. § 1.881-3.

\textsuperscript{71} Schier, \textit{supra} n. 55, at pp. 39-40: ‘The rule does not apply to payments for goods (except for a special rule when the payment to a surrogate foreign corporation following an inversion). As a result, it may be preferable for a U.S. corporation to buy finished goods from a foreign affiliate rather than (1) pay the foreign affiliate to act as a contract manufacturer for the U.S. company (a service payment), or (2) manufacture the goods itself and pay the foreign affiliate a royalty for the use of the trademark.’ Kamin et al., \textit{supra} n. 55 at p. 22: ‘Royalty payments from a U.S. firm to its foreign affiliate, which holds intellectual property, would be included in the expanded base. If a foreign affiliate incorporates the foreign-held intellectual property into a product and then sells the product back to a U.S. affiliate, this could be considered cost of goods sold that is not captured by the inbound regime.’ Stevens & Barnes, \textit{supra} n. 69, at p. 2: ‘A U.S. company pays royalties to a foreign affiliate (which may be a foreign parent of the U.S. company, or a foreign subsidiary if the taxpayer is a U.S. headquartered company.) The U.S. company uses the
Finally, can the BEAT be seen as violating the non-discrimination provision of Article 24? Article 24 has two relevant provisions: Article 24(4) and (5). Under Article 24(4):

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

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

In addition, the BEAT can be seen as conceptually similar to a broadly applied thin capitalization rule. In fact, the BEAT replaces the old earnings stripping rule (former IRC § 163(j)). And thin capitalization rules, even though they do frequently involve denying the interest deduction for interest paid to foreign but not domestic intellectual property to manufacture goods in the U.S. (which, significantly, provides U.S. jobs).

If the U.S. company cannot include the royalty payment in COGS, the payment will be subject to the BEAT tax, but no BEAT tax applies if the foreign affiliate performs the manufacturing and the U.S. company purchases the finished goods. The BEAT tax thus puts enhanced pressure on the tax accounting rules and creates a significant financial incentive to push manufacturing to foreign affiliates [emphasis added]. However, Koonitz and Kadet noted how the base erosion provision in the Senate version would actually miss the bulk of the profit shifting that many companies conduct, arguing that, 'Today, many such companies do not physically manufacture their own products. They may conduct all the “production activities” except the physical manufacture at their headquarters in the United States, but they farm out the physical manufacture of their products by contracting with unrelated foreign manufactures. So when a U.S. group member sources inventory for sales to U.S. customers, it’s not buying that inventory from a related foreign party. In those cases, there are no base-eroding payments to related parties and no profit shifting.’ See D.L. Koonitz & J.M. Kadet, Internet Platform Companies and Base Erosion – Issue and Solution, 2017 TNT 243-8 (20 Dec. 2017).

72. Section 163(j) was amended in TRA17 to apply a 30% of earnings limit on all business interest, whether paid to domestic or foreign parties.
related parties, are widely used and generally regarded by the OECD as non-discriminatory.\footnote{See OECD, Committee on Fiscal Affairs, \textit{Report on Thin Capitalisation} (1986). There was some diversity of opinion about whether Art. 9 is held to be 'restrictive' or merely 'illustrative' in its scope. Some considered that Art. 9(1) prohibits an adjustment of the profits of a taxpayer beyond arm's length amounts. Others argued that while Art. 9(1) permits the adjustment of profits up to the arm's length amount, it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. Note that in the case of interest, comparables always exist, but IRC s. 163(j) applied to deny the interest deduction regardless of whether the interest rate was excessive based on the comparables. Nevertheless, there was no challenge to s. 163(j) as discriminatory. See H. Ault and J. Sasseville, \textit{Taxation and Non-Discrimination: A Reconsideration}, Boston College Law School Faculty Papers, Paper 286 (2010), http://lawdigitalcommons.bc.edu/lspf/286 (accessed 5 Apr. 2018).}

The other relevant provision of Article 24 is paragraph 5, which states that a country may not apply less favourable treatment to any entity owned or controlled by non-residents in comparison with domestically held entities.\footnote{Article 24(5): 'Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned Contracting State are or may be subjected.'}

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

Second, the first author argued that the foreign related party and the US related party are not comparable for applying a non-discrimination analysis. The reason is that the United States knows that a US related party is in fact subject to tax on the relevant deductible items, such as interest, royalties, and in some cases, cost of goods sold. But the United States does not know that the foreign related party is similarly subjected to tax by its country of residence because in many cases these countries will not tax, particularly when it comes to foreign-source interest or royalties. It should be expected that the enactment of the BEAT would lead multinationals to establish related parties that receive deductible payments from US parties precisely in those jurisdictions that exempt such payments because otherwise they would risk double taxation since a credit would normally not be immediately available.

The guiding spirit behind the international provisions of the TCJA is the single tax principle and under that principle it is perfectly appropriate for the United States to deny a deduction for items that it has no reason to believe will be taxed on a residence basis. No violation of Article 24(5) should arise under those circumstances. Therefore, rather than engaging in retaliatory actions, EU treaty partners should adopt similar measures and apply them to US multinationals.\footnote{I. Grinberg, \textit{The BEAT is a Pragmatic and Geopolitically Savvy Inbound Base Erosion Rule} (12 Nov. 2017), http://scholarship.law.georgetown.edu/facpub/2009 (accessed 5 Apr. 2018). Wells, \textit{supra} n. 67, at p. 1030: 'Instead of criticizing the BEAT, the appropriate European
§1.05 BEPS ACTION 6: SHOULD THE US RECONSIDER THE REJECTION OF THE PPT?

One of the key BEPS Actions that generated the most controversy in the United States and eventually led the United States not to join the MLI was Action 6, primarily due to the inclusion of a general anti-abuse rule based on the principal purposes of transactions or arrangements (the PPT rule). Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits will be denied unless it is established to grant them would be in accordance with the object and purpose of the provisions of the treaty. In order to understand why the United States opposed this subjective intention-based test and preferred a more objective detailed LOB provision, which has been part of its treaty policy since 1981, it is necessary to go back to the beginning of the twenty-first century when the US Senate refused to approve the ratification of negotiated treaties with Italy and Slovenia that originally contained a ‘main purpose’ clause.

The Italian negotiators wanted to include a very broad anti-abuse provision which would have denied treaty benefits in situations not covered by the LOB clause. At that time (second half of the 1990s), Italy did not have effective domestic anti-abuse rules, which could have been used to deny treaty benefits in the case of abusive transactions, and was therefore increasingly relying on explicit anti-abuse provisions in its treaties. Indeed, Italian domestic anti-abuse provisions were so weak that, in three cases of the early 2000s, the tax authorities tried unsuccessfully to fight dividend washing transactions through the principle of fraude à la loi set forth by Article 1344 of the Civil Code. In particular, Italian negotiators wanted to incorporate a provision similar to Article 30 of the 1995 treaty with Israel, which reads as follows: ‘The competent authorities of the Contracting States, upon their mutual agreement, may deny the benefits of this Convention to any person, or with respect to any transaction, response would be to adopt their own form of a BEAT to protect their own tax base from excessive BEPS practices ... If all European countries adopted their own forms of a BEAT to protect their tax bases against excessive use of base erosion payments by MNEs, the effect would be that the developed nations of Europe would preserve their rights to at least a reasonable split on the combined profits of associated enterprise that conduct operations within those countries.’


76. The Technical Explanation to Art. 10(10) of the 1999 treaty with Italy listed dividend washing among those abusive transactions that would have been subject to the main purpose test. A typical example of a cross-border dividend washing transaction is when a shareholder in one country (the ‘customer’) that does not qualify for treaty benefits sells shares in a US company to a bank resident in Italy (the ‘intermediary party’) shortly before a dividend is paid on the shares. Once the dividend has been paid, the intermediary party will resell the participation to customer, the original shareholder, at a fixed price. The intermediary party, being an Italian resident,
if in their opinion the receipt of those benefits, under the circumstances, would constitute an abuse of the Convention according to its purposes.\(^77\)

However, in a hearing before the US Senate Committee on Foreign Relations, Phil West, International Tax Counsel for the US Department of the Treasury, declared that this broad, subjective anti-abuse rule in the Israel-Italy treaty was rejected for several reasons:

First, it provided a less certain standard against which a taxpayer could meaningfully evaluate its transaction. Second, since the narrower rule ("main purpose" test) before you appears in a significant number of treaties around the world, and promises to appear in more, it is more consistent with international norms and will likely be the subject of more interpretive law than the other standards...

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\(^{77}\) Article 30, Israel-Italy Income and Capital Tax Treaty (1995). Anti-abuse provisions included in certain of Italy's other bilateral treaties appear to be narrower than this. See Art. 28 Estonia-Italy Income Tax Treaty (1997): '1. Notwithstanding any other provision of this Convention, a resident of a Contracting State shall not receive the benefit of any reduction in or exemption from taxes provided for in this Convention by the other Contracting State if the main purpose or one of the main purposes of the creation or existence of such resident or any person connected with such resident was to obtain the benefits under this Convention that would not otherwise be available. 2. Nothing in this Convention shall affect the application of the domestic provisions to prevent fiscal evasion and tax avoidance concerning the limitation of expenses and any deductions arising from transactions between enterprises of a Contracting State and enterprises situated in the other Contracting State, if the main purpose or one of the main purposes of the creation of such enterprises or of the transactions undertaken between them, was to obtain the benefits under this Convention, that would not otherwise be available [emphasis added].'

Article 30 Italy-Latvia Income and Capital Tax Treaty (1997); Art. 30 Italy-Lithuania Income and Capital Tax Treaty (1996); Art. 29 Italy-Kazakhstan Income Tax Treaty (1994): 'A person that is a resident of a Contracting State and derives income from the Contracting State shall not be entitled to relief from taxation in that other State otherwise provided for in this Convention if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of such item of income to take advantage of the provisions of this Convention. In making a determination under this Article, the appropriate competent authority or authorities shall be entitled to consider, among other factors, the amount and nature of the income, the circumstances in which the income was derived, the stated intention of the parties to the transaction, and the identity and residence of the persons who in law or in fact, directly or indirectly, control or beneficially own (i) the income or (ii) the persons who are resident(s) of the Contracting State(s) and who are concerned with the payment or receipt of such income [emphasis added].'
We gravitated toward the 'main purpose' standard of our proposed rule because it corresponds to the U.S. 'a principal purpose' standard which is applied in a number of our statutory provisions and regulations.\(^\text{78}\)

78. From a search in Westlaw, it can be seen that the language 'principal purpose' is included in almost thirty provisions of the IRC; § 269. Acquisitions made to evade or avoid income tax ... and the principal purpose for which such acquisition was made is evasion or avoidance ...); § 877. Expatriation to avoid tax ... such loss of citizenship did not have for one of its principal purposes the avoidance of taxes ...); § 7872. Treatment of loans with below-market interest rates ... Any below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of ...); § 954. Foreign base company income ... to any transaction or series of transactions one of the principal purposes of which is qualifying income or gain for the exclusion ... this section, including any transaction or series of transactions a principal purpose of which is the acceleration or deferral of any item ...); § 614. Definition of property ... the Secretary shall, on showing by the taxpayer that a principal purpose is not the avoidance of tax ...); § 9722. Sham transactions ... If a principal purpose of any transaction is to evade or avoid liability under this chapter ...); § 6105. Relief from joint and several liability on joint return ... by the other individual filing such joint return if the principal purpose of the transfer was the avoidance of tax or payment ...); § 357. Assumption of liability ... it appears that the principal purpose of the taxpayer with the respect to the assumption ... was a purpose to avoid Federal income tax on the exchange ...); § 453. Instalment method ... neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax ...); § 1298. Special rules ... a principal purpose of leasing the property was to avoid the provisions of this part ...); § 1272. Current inclusion in income of original issue discount ... Clause (i) shall not apply if the loan has as one of its principal purposes the avoidance of any Federal tax ...); § 336. Gain or loss recognized on property distributed in complete liquidation ... the acquisition of such property by the liquidating corporation was part of a plan a principal purpose of which was to recognize loss by the liquidating corporation with respect to such property in connection with the liquidation ...); § 1031. Exchange of real property held for productive use or investment ... neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax ...); § 311. Taxability of corporation on distribution ... to property contributed to the partnership or trust for the principal purpose of recognizing such loss on the distribution ...); § 306. Dispositions of certain stock ... in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax ...); § 7874. Rules relating to expatriated entities and their foreign parents ... The transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are plan of a plan a principal purpose of which is to avoid the purposes of this section ...); § 409. Qualifications for tax credit employee stock ownership plans ... a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of this subsection ...); § 751. Unrealized receivables and inventory items ... there shall be excluded any inventory property if a principal purpose for acquiring such property was to avoid the provisions of this subsection relating to inventory items ...); § 269A. Personal service corporations formed or availed of to avoid or evade income tax ... the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax ...); § 170. Charitable, etc., contributions and gifts ... No deduction shall be allowed under this section for a contribution ... if a principal purpose of the contribution was to avoid Federal income tax ...); § 467. Certain payments for the use of property or services ... a principal purpose for providing increasing rents under the agreement is the avoidance of tax imposed by this subtitle ...); § 965. Treatment of deferred foreign income upon transition to participation exemption system of taxation ... If the Secretary determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account under this subsection, such transaction shall be disregarded for purposes of this subsection ...); § 953. Insurance income ... there shall be disregarded any change in the method of computing reserves a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of this subs. or s. 954(i) ...); § 197. Amortization of goodwill and certain other intangibles ... The term 'amortizable section 197 intangible' does not include any s. 197 intangible acquired in a transaction, one of the principal purposes of which is to avoid the requirement of subs. (c)(1) that the intangible be acquired after the date of the enactment of this
A compromise was thus reached on the inclusion of the ‘main purpose’ clause in Articles 10 (Dividends), 11(9) (Interest), 12(8) (Royalties) and 22(3) (Other Income). Article 10(10) of the 1999 treaty with Italy provided that:

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.79

section or to avoid the provisions of subparagraph (A) ...); § 643. Definitions applicable to subparts A, B, C, and D ... a principal purpose of such trusts is the avoidance of the tax imposed by this chapter ...); § 864. Definitions and special rules ... there shall be disregarded any item of income or gain from a transaction or series of transactions a principal purpose of which is the qualification of any corporation as a financial corporation...); § 355. Distribution of stock and securities of a controlled corporation ... the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax ...); § 382. Limitation on net operating loss carryforwards and certain built-in losses following ownership change ... Any capital contribution received by an old loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under this section shall not be taken into account for purposes of this section ...); § 302. Distributions in redemption of stock ... The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax ...). Emphasis added by authors.

79. The main purpose test was apparently modelled on similar provisions found in treaties of other countries, such as many of the modern treaties of the United Kingdom. A search in the IBFD database shows that the United Kingdom had included such standard in almost thirty of its tax treaties entered into force between 1 Jan. 1930 and 31 Dec. 1999. The predecessor to the main purpose standard first appeared in Art. 12(5) of the 1976 treaty with Ireland: 'The provisions of this Article shall not apply if the debt-claim in respect of which the interest is paid was created or assigned mainly for the purpose of taking advantage of this Article and not for bona fide commercial reasons [emphasis added];' followed by the 1992 treaty with Guyana, see Art. 12(9) (Interest): 'The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment [emphasis added],' Arts 13(7) (Royalties) and 14(7) (Technical fees). Starting from 1993, it was then included in the treaty with Ghana: Articles 11(9), 12(7) and 17(8) (Management and technical fees); in the 1993 treaty with India: Articles 12(11) and 13(9); in the 1993 treaty with Ukraine: Articles 11(7) and 12(5); in the 1993 treaty with Indonesia: Articles 11(9) and 12(7); in the 1993 treaty with Uzbekistan: Articles 11(9), 12(7), 21(3) (Other Income) and 23(2) (Limitation of relief); in the 1994 treaty with Russia: Articles 11(6) and 12(5); in the 1994 treaty with Azerbaijan: Articles 11(8), 12(7), 21(3) and 23(2); in the 1994 treaty with Kazakhstan: Articles 11(9), 12(8), 21(3) and 23(2); in the 1994 treaty with Vietnam: Articles 11(7) and 12(7); in the 1994 treaty with Malta: Articles 11(7), 12(7) and 21(3); in the 1994 treaty with Estonia: Articles 11(9), 12(7), 22(3) and 24(2); in the 1994 treaty with Mexico: Articles 11(11), 12(7) and 21(3); in the 1994 treaty with Bolivia: Articles 11(8) and 12(7); in the 1996 treaty with Argentina: Articles 11(9), 12(7) and 21(4). The 1996 UK-Venezuela Income Tax Treaty was the first to include such standard in the Dividends article as well, see Art. 10(7): 'The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment [emphasis added].' Articles 11(9), 12(7) and 21(5) of the 1996 treaty with Mongolia: Articles 10(6), 11(10), 12(7), 22(4) and 25(2); in the 1996 treaty with Latvia: Articles 11(8), 12(7), 22(4) and 24(2); in the 1996 treaty with Korea (Rep.): Articles 10(6), 11(10), 12(7) and 22(4); in the 1996 treaty with Malaysia: Articles 10(6), 11(7) and 12(7); in the 1997 treaty with Lesotho: Articles 10(6), 11(9), 12(7), 13(8) and 22(4); in the 1997 treaty with Singapore: Articles 10(7), 11(9) and 12(8); in the 1997 treaty with the Falkland Islands: Articles 10(6), 11(5), 12(5)
Lindy Paull, Chief of Staff of the Joint Committee on Taxation, told the US Senate Committee on Foreign Relations that:

While the main purpose tests are intended to prevent inappropriate benefits under the treaty, such tests inject considerable uncertainty into the treaty provisions because such tests are subjective and vague. This uncertainty can create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty.\(^8^0\)

The US Senate Committee on Foreign Relations, in turn, stated that the inclusion of such tests represented a fundamental shift in US treaty policy, which was based on clear, bright-line objective tests (such as ownership and base erosion tests, and public company tests, as well as active business tests). In this regard, the Committee complained that it had not been afforded an opportunity to weigh the relevant policy considerations. Accordingly, the Committee placed a reservation on the main purpose test, citing subjectivity, vagueness and uncertainty as sources of the serious concerns about the provision. The reservation had the effect of striking the objectionable provision from the instrument of ratification.\(^8^1\)

In the authors' opinion, Phil West's memorandum to Senator Hagel (R-NE) appears to be contradictory while seeking to give meaning to the term 'a principal purpose.' On the one hand, West cited Judge Posner's ruling in \textit{Santa Fe Pacific Corporation v. Central States, Southeast and Southwest Areas Pension Fund}, a labour law case governed by the Employee Retirement Income Security Act rules. On the other hand, he listed § 877(a)(2) among the IRC provisions using 'a/one of the principal purposes' anti-abuse language. First, \textit{Santa Fe} was not a tax case and did not interpret and 22(4); and in the 1998 treaty with Oman: Articles 10(6), 11(5), 12(5), 21(4) and 23. However, it should be noted that Art. 2(2) of the Protocol to the 1984 Italy-US Income Tax Treaty already included 'a principal purpose' standard: 'Paragraph 1 shall not apply unless the competent authority of the other Contracting State determines that either the establishment, acquisition or maintenance of such person or the conduct of its operations had as a principal purpose obtaining benefits under the Convention [emphasis added].' The Technical Explanation to Art. 2 of the 1984 Protocol (1985) states: 'This provision recognizes that ownership of an entity that is a resident of the United States or Italy by persons resident in third countries is not uncommon, and that granting Treaty benefits to such an entity may be consistent with the goals of the Treaty. For example, this test would be met if an Italian company owned by third country residents conducts business operations in Italy and its U.S. investments are related or incidental to those business activities, or if the aggregate Italian tax burden equals or exceeds the tax reduction claimed under the Convention. It could also be met in other situations.'

81. L.A. Sheppard & A. Adelchi Rossi, \textit{Where Is the Italian Tax Treaty?}, 39 Tax Notes Int'l (29 Aug. 2005) at pp. 791 et seq.; see also Diplomatic Note, 2007 U.S.-Italy Diplomatic Note: 'Ratification of the Convention by the Government of the United States of America is subject to the deletion of the final paragraph of Article 10 (Dividends), the final paragraph of Article 11 (Interest), the final paragraph of Article 12 (Royalties), the final paragraph of Article 22 (Other Income) of the Convention and paragraph 19 of Article 1 of the Protocol, with the renumbering of paragraph 20 of Article 1 of the Protocol as paragraph 19. The Embassy of the United States wishes to seek confirmation that the Government of the Italian Republic agrees to these deletions.' See also C.P. Tello, \textit{Financial Products Anti-Abuse Provisions in New Income Tax Treaties Rejected by Senate}, 2 Derivs. & Fin. Instrums. 2 (2000), pp. 123–128.
any provisions of the IRC. Second, its conclusions are completely at odds with those of several judicial decisions involving §§ 367 and 877. Santa Fe might have caused enough confusion to lead the Senate to reject the inclusion of the ‘main purpose’ test in the tax treaties with Italy and Slovenia.

Under the Multiemployer Pension Plan Amendments Act of 1980, an employer that withdrew from a multi-employer pension plan could have been required to pay the plan a sum equal to the vested but unfunded benefits of the employer’s employees. The purpose was to avoid situations where the other employers would have had to pay for those benefits. A parent and its subsidiaries were considered to be a single employer with the consequence that if a subsidiary withdrew from the plan, its withdrawal liability could have been assessed against the parent. But in the event that the parent had sold its subsidiary, the parent would have not been liable for withdrawal liability unless ‘a principal purpose’ of the transaction was to ‘evade or avoid’ parental liability. In determining whether a principal purpose of Santa Fe was to evade or avoid its parental liability, the Court held:

The imposition of withdrawal liability in a sale of business situation requires only that a principal purpose of the sale be to escape withdrawal liability. It needn’t be the only purpose; it need only have been one of the factors that weighed heavily in the seller’s thinking. We can find no decisions discussing situations in which there is more than one principal (major, weighty, salient, important) purpose, but we would be doing violence to the language and the purpose of the statute if we read ‘a principal’ as ‘the principal.’ The clear import of ‘a principal’ is to let the employer off the hook even if one of his purposes was to beat withdrawal liability, provided however that it was a minor, subordinate purpose, as distinct from a major purpose. To let the employer off even if avoiding such liability was a major purpose would ill serve the statute’s goal of preventing one employer from unloading his pension obligations onto the other employers in a multiemployer plan.

However, such interpretation of the term ‘a principal purpose’ contrasts starkly with settled case law involving IRC provisions, such as §§ 367 and 877. As mentioned above, Phil West adopted Judge Posner’s interpretation of the term ‘a principal purpose’ while, at the same time, he made reference to § 877 as one of the many Code provisions which contains such language. A 1984 Tax Court case, regarding whether the petitioner had tax avoidance as one of her principal purposes in expatriating, clearly illustrates West’s inconsistency.

Until 20 August 1996, when it was amended by the Health Insurance Portability and Accountability Act (P.L. 104-191, § 511(g)), § 877 generally provided that a non-resident alien individual who lost his US citizenship should be subject to tax on his US-source income, for the ten year period following such loss, at the graduated tax

83. Santa Fe Pacific Corp., at pp. 727-728.
rates applicable to US citizens rather than more favourable rates applicable to non-resident aliens, unless the loss did not have as one of its principal purposes the avoidance of US taxes. Section 877(e) specifically placed the burden of proving the lack of a tax avoidance motive to the expatriate if the respondent established that it was reasonable to believe that the individual’s loss of US citizenship would result in a substantial reduction in taxes. In Furstenberg v. Commissioner, the taxpayer was able to carry her burden under § 877(e). Furstenberg was the daughter of Robert Lee Blaffer, one of the founders of Humble Oil & Refining Co., the predecessor of Exxon Corporation. Because of the financial success of her father, the petitioner travelled extensively with her family, visiting Europe, in particular, France, where she spent several summers. By the time of her expatriation (23 December 1975), she was divorced from her second husband, Richard M. Sheridan, an international executive of Mobil Oil Corporation. The genesis for the expatriation was her third marriage to Prince Tassillo von Furstenberg (17 October 1975), a member of the Austrian aristocracy, whose ancestors were princes of the Holy Roman Empire in 1664. At the time of their decision to marry in early 1975, Furstenberg explained to the petitioner how important she was to him, given his Austrian heritage and ties, the fact that she should have adopted Austrian citizenship. Prior to expatriating, she met with her accountant and informed him that she intended to marry Furstenberg, adopt Austrian citizenship and live with her husband in Paris. He told her that adopting Austrian nationality would ‘complicate’ her taxes and warned that French taxes could be very high. The Petitioner had no further discussions with her accountant in 1975. Her income in 1975 and 1976 came from two trust distributions she received and from the sale of securities. The distribution from Trust No. 1, a complex inter vivos trust established by her parents, occurred on the day of her expatriation. In addition, in 1976 and 1977, after her expatriation she sold various securities realizing net capital gains in the amounts of USD 2,601,680.06 and USD 7,219,440.35 respectively. After careful consideration of all the evidence, the court was convinced that tax avoidance was not one of her principal purposes in expatriating. Interestingly, the Tax Court held the following:

Although we have never specifically interpreted the phrase ‘one of its principal purposes’ in the context of section 877, we find instructive the following definition set forth in Dittler Bros, Inc. v. Commissioner, 72 T.C. 896, 915 (1979), affd. without published opinion 642 F.2d 1211 (5th Cir. 1981), in which the Court was called upon to determine, under section 367, whether or not a certain translation was ‘in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax....’

The Court then quoted the definition of the term ‘principal purpose’ as articulated in Dittler Bros., according to which:

[T]he term [principal purpose] should be construed in accordance with its ordinary meaning. Such a rule of statutory construction has been endorsed by the Supreme Court. Malat v. Riddell, 383 U.S. 569, 571 (1966). Webster’s New

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Collegiate Dictionary defines ‘principal’ as ‘first in rank, authority, importance, or degree.’ Thus, the proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its ‘first-in-importance’ purposes the avoidance of Federal income taxes.

To better understand the logic of Furstenberg’s conclusions it is necessary to closely examine Dittler Brothers, Inc. v. Commissioner of Internal Revenue, which interpreted the term ‘principal purpose’ within the context of § 367.

Prior to the Deficit Reduction Act of 1984, § 367(a)(1) provided that certain outbound transfers of appreciated property would be non-taxable only if the exchange did not have the avoidance of Federal income taxes as one of its principal purposes. This determination was made by the IRS in accordance with guidelines set out in Rev. Proc. 68-23, 1968-1 C.B. 821. Section 1042(d) of the Tax Reform Act of 1976 afforded taxpayers a remedy through a declaratory judgment procedure in the Tax Court in cases where the IRS issued an adverse ruling or failed to make a determination as to whether a transfer had tax avoidance as a principal purpose. However, the scope of a Tax Court declaratory judgment was limited as to whether the IRS acted reasonably.

In Dittler Bros., the taxpayer had special know-how and trade secrets regarding the manufacturing of ‘rub-off’ lottery tickets. In order to expand its sales into foreign markets, Dittler entered into a 50-50 joint venture with a UK holding company, known as Norton & Wright Group Ltd. (NWG), which had developed a substantial market for the sale of lottery tickets. Dittler had previously granted two non-exclusive licences of its secret process to foreign companies, but since only nominal royalties were produced, both licences were cancelled. Dittler and NWG created two Netherlands Antilles corporations. NWG’s representatives requested the joint venture to be located there primarily due to potential tax benefits: a low rate of Netherlands Antilles tax plus Netherlands tax exemption for dividends received. The first corporation, known as Stansfield Security N.V. (SSNV), was owned 50% by Dittler and 50% by Norton & Wright (Holland) B.V. (NWBV), a NWG’s wholly owned Netherlands subsidiary. The second corporation, known as Opax Lotteries International N.V. (OUNV), was wholly owned by SSNV. Dittler and NWBV each contributed USD 25,000 to SSNV as partial consideration for their respective 50% stock interest. In addition, Dittler transferred its secret process for the printing of rub-off tickets to SSNV while NWBV transferred, along with its cash contribution, specific marketing and customer information. Subsequently, SSNV transferred 80% of its cash, the manufacturing know-how and the marketing information to OUNV for 100% of its stock. This contribution qualified SSNV as an investment holding company under Netherlands Antilles law. Under the terms of a shareholder agreement, 75% of the net profits after taxes of OUNV would be declared and paid out as a dividend distribution to SSNV. SSNV would in turn declare and pay, pro rata, dividend distributions to its shareholders from the dividends received from OUNV. Accordingly, the fight with the IRS concerned whether the retention of 25% of OUNV’s after-tax earnings was pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes.

The Tax Court determined that Dittler was denied a favourable ruling on two grounds. First, the IRS concluded that neither SSNV nor OUNV would devote the property received (manufacturing know-how) to the active conduct of a trade or
business, within the meaning of § 3.02(1) of Rev. Proc. 68-23, 1968-1 C.B. 821. Second, the transaction created a potential for tax avoidance in that income from the exploitation of the manufacturing know-how would be diverted to a passive recipient in a benign foreign tax country.

Perhaps the most significant part of the judgment is when the Court stated that:

Neither Congress in its hearings nor respondent in his rulings has ever defined what is meant by a 'principal purpose.'

Although we have never interpreted the term principal purpose within the context of section 367, we have interpreted the meaning of principal purpose in a somewhat analogous provision under section 269. That section, unlike section 367, focuses on whether the principal purpose for which an acquisition was made is the evasion or avoidance of Federal income tax. For section 269 to apply, principal purpose has been interpreted to mean a tax-evasion or avoidance purpose which outranks or exceeds in importance, any other purpose. VGS Corp. v. Commissioner, 68 T.C. 563, 595 (1977); Capri, Inc. v. Commissioner, 65 T.C. 162, 178 (1975).

In contrast to section 269, section 367 speaks in terms of a plan having as one of its principal purposes the avoidance of Federal income taxes. When these two statutory provisions are laid side by side, it becomes apparent that the subjective tax-avoidance motive in section 269 acquisitions must be greater than the tax-avoidance motive in section 367 transfers. Consequently, section 269 is instructive in the instant case by defining the nature and scope of the tax-avoidance purpose.

However, because of the statutory variance between section 269 and section 367, with respect to the intendment of the respective statutes, we believe that the term 'principal purpose' should be construed in accordance with its ordinary meaning. Such a rule of statutory construction has been endorsed by the Supreme Court. Malat v. Riddell, 383 U.S. 569, 571 (1966). Webster's New Collegiate Dictionary defines 'principal' as 'first in rank, authority, importance, or degree.' Thus, the proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its 'first-in-importance' purposes the avoidance of Federal income taxes [emphasis added].

In conclusion, the issue centres on the correct meaning of the term "principle purpose". In other words, is "a principal purpose" standard met only when the avoidance of tax exceeds in importance any other purpose as stated in Dittler? Or is the standard also operative when the tax-avoidance motive was only one of the factors that weighed heavily in the taxpayer's thinking as argued in Santa Fe? Obviously, on the one hand, taxpayers would prefer the former interpretation, which is more lenient, because this allows them to preserve treaty benefits by asserting a relatively weak business purpose, while, on the other hand, tax authorities would prefer the latter, stricter, interpretation because it permits them to deny treaty benefits if tax avoidance was just more than a trivial or de minimis purpose.

85. Dittler Brothers, Inc. v. Commissioner of Internal Revenue, USTC, 27 Aug. 1979, 72 T.C. 896, at pp. 914-915.
Analysis of the legislative history\(^{86}\) and regulations of § 129 of the 1939 IRC,\(^ {87}\) predecessor to § 269,\(^ {88}\) as well as the extensive case law before\(^ {89}\) and after\(^ {90}\) Dittler, clearly suggests that any standard using a principal purpose is met only when the purpose of evading tax exceeds in importance any other purpose.\(^ {91}\)

Therefore, if the United States' ultimate goal were to incorporate these new anti-abuse rules in its Model Treaty and, at the same time, provide certainty to its business community that other countries' tax authorities will not inappropriately invoke the main purpose provisions to challenge legitimate business transactions, why cite the ambiguous *Santa Fe* ruling? In the authors' opinion, the United States should have requested the inclusion of an additional provision in the Protocol to the tax treaty with Italy, clarifying the scope of the 'main purpose' provision, which reads as follows: ‘As was discussed and understood among the negotiators, the following Articles 10(10); 11(9); 12(8) and 22(3) should be operative only if the tax evasion or avoidance purpose outranks or exceeds in importance, any other purpose.’

The rejection of 'main purpose' tests in the tax treaties with Italy and Slovenia based on the incorrect interpretation of the term given in *Santa Fe* could be considered a posteriori to have been a strategic mistake. Oddly, in 1999, the United States did not take advantage of the opportunity to play a leadership role in shaping the future.

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87. Regulations 118, § 39.129-3 which provides in part: ‘If the purpose to evade or avoid Federal income or excess profits tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of s. 129 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom [emphasis added].’


direction of this important principle. The fact that the PPT rule is currently included in more than 1,100 matched agreements demonstrates how important it was to the United States in 1999 to adopt such a standard in the tax treaties with Italy and Slovenia. However, as mentioned, the inclusion of this standard should have been explicitly based on the Dittler ruling, the only approach able to ensure a consistent and reasonable application of the standard. In 1999, the United States lost the chance to unilaterally impose its own interpretation of the PPT rule. Today, with the United States refusing to sign up to the MLI, the concerns of Ms Paull and of Sen. Hagel as to whether other countries’ tax authorities would appropriately administer this provision are more important than ever.

§1.06 ANTI-HYBRID PROVISIONS

Similarly to the ATAD, TRA17 contains two anti-hybrid provisions that directly implement the single tax principle. The first, § 14101 of the Senate amendment, the new § 245A(e), disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. The second, § 14223 of the Senate amendment, the new § 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.

In particular, on the one hand, § 245A(e)(1) provides that the dividend received deduction is not available for any dividend received by a US shareholder from a CFC if the dividend is a ‘hybrid dividend’. Hybrid dividend is defined as, ‘an amount received from a controlled foreign corporation for which a deduction would be allowed under this provision and for which the specified 10-percent owned foreign corporation received a deduction (or other tax benefit) from taxes imposed by a foreign country’.

In addition, if a CFC receives a hybrid dividend from another CFC, the hybrid dividend is treated as Subpart F income. Finally, § 245A(e)(3) provides, by reference to § 245A(d)(1) and (2), that no foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a hybrid dividend.

On the other hand, § 267A(a) denies a deduction for any ‘disqualified related party amount’ paid or accrued pursuant to a ‘hybrid transaction’ or by, or to, a ‘hybrid entity’. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (i) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax

92. Section 245A(e)(4).
93. Section 245A(e)(2). See Conference Report to TRA17, at p. 598: ‘If a controlled foreign corporation with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from any other controlled foreign corporation with respect to which the domestic corporation is also a U.S. shareholder, then the hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of the recipient controlled foreign corporation for the taxable year of the controlled foreign corporation in which the dividend was received and the U.S. shareholder includes in gross income an amount equal to the shareholder’s pro rata share of the subpart F income, determined in the same manner as section 951(a)(2).’
purposes or is subject to tax, or (ii) such related party is allowed a deduction with respect to such amount under the tax law of such country. A hybrid transaction is defined as ‘any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax’. Finally, a hybrid entity is any entity which is either: (i) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or (ii) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for Federal income tax purposes.

It may seem strange that the United States took this action while making the CFC-to-CFC look-through rule § 954(c)(6) permanent and thereby facilitating foreign-to-foreign profit shifting from high- to low-tax jurisdictions abroad. The fundamental question is whether all of this is consistent with the spirit of BEPS. Eventually, the United States will tax at residence if there is no tax at source (§ 245A(e)) and will tax at source if there is no tax at residence (§ 267(a)). But what about the case where both source and residence are foreign? The United States will not impose tax and will leave this situation to the foreign jurisdictions to resolve by adopting their own anti-BEPS rules, like the new ATAD II. Again, a strategic mistake made by the United States?

Early commentators highlighted how TRA17 prevents the use of hybrid instruments or entities that could reduce the US tax base but does not have any material impact on ‘foreign-to-foreign hybrid planning, the type of United States multinational planning that many countries blame on the United States check-the-box rule.’ In the same vein, a Baker McKenzie Client Alert stated:

The new provision is a very limited version of the much broader anti-hybrid provisions recommended by the OECD under BEPS Action 2. In particular, the rules only apply to interest and payments, and only to outbound payments. There is no equivalent provision that subjects hybrid income paid by a foreign related party to tax in the US where that income would otherwise escape US tax. Moreover, the definitions of ‘hybrid entity’ and ‘hybrid transaction’ are relatively narrow, so that the new Code Section would not seem to apply, for example, to permanent establishment hybrid mismatches [emphasis added].

Thus, neither § 245A(e) nor § 267A(a) will significantly impact foreign reverse hybrid entities, i.e., entities that are treated as opaque by a foreign investor and transparent under the jurisdiction where they are established, such as a Dutch CV-BV or a Luxembourg SCS-Sarl structure. This might have adverse consequences for both

94. Section 267A(b)(1)(A).
95. Section 267A(b)(1)(B).
96. Section 267A(c). See Conference Report to TRA17, at p. 663.
97. Section 267A(d)(1).
98. Section 267A(d)(2).
US multinationals and tax authorities, considering that ATAD II also includes specific rules aimed at reverse hybrid mismatches, namely Article 9a.

Over the past few years, US multinationals have widely used either a Dutch CV-BV (Starbucks) or a Luxembourg SCS-Sarl structure (Amazon) in order to defer US taxation on their non-US earnings.\footnote{This description is derived from a Jones Day presentation held at the International Tax Seminar organized by the Detroit Chapter of Tax Executives Institute on 27 Apr. 2016; see, http://teidetroitchapter.camp7.org/resources/Documents/Jones%20Day%20-%202016%20DET%20-%20International%20 Tax%20Seminar%202016v2.pdf, at pp. 249–250 (Accessed 20 Jun. 2018); see also J. Vleggeert, Dutch CV-BV Structures: Starbucks-Style Tax Planning and State Aid Rules, 70 Bull. Intl. Taxn. 3 (2016), at pp. 173–174: ‘Specifically, a US MNE establishes a “closed” Dutch limited partnership (CV). A US-resident subsidiary of the US MNE is a more-than-95% limited partner in the CV. The less-than-5% general partner is usually resident in a tax haven, for example Bermuda. The CV holds all the shares in a Dutch operating company (BV). The BV may also be engaged in “real” activities, such as the production or production of goods. In addition, the CV may function as an intangible property (IP) holding company. Furthermore, the CV may enter into loan agreements with the BV and/or its subsidiaries and other group companies to lend surplus cash back to group companies. The benefit of the CV-BV structure is that the earnings of the subsidiaries are channelled into the CV by means of distributions of dividend or payments of interest and royalties. In a CV-BV structure, the BV typically licenses IP from the CV for which the BV pays royalties to the CV. The amount of the royalties payable by the BV to the CV depends on the difference between the pre-tax profit for accounting purposes before the payment of the royalties and the remuneration established in the advance pricing agreement (APA) concluded between the BV and the Dutch tax authorities.’} A US multinational establishes a limited partnership under Dutch (CV) or Luxembourg (SCS) law, which is a fiscally transparent entity under local law but elects to be treated as a corporation for US tax purposes. The CV/SCS licenses international IP rights from the US parent company and further develops such IP under a research and development (R&D) contract (CRA) or cost-sharing (CSA) arrangement with the US parent. It then grants an IP licence to a Dutch (BV) or Luxembourg (Sari) principal. The BV/Sari may either (i) sell products throughout Europe and retain local in-country service companies for support services or (ii) grant sub-licences to European operating companies.

The tax consequences are the following: (i) service or operating companies across Europe remit local country tax on routine income; (ii) the BV remits 25% tax on net sales or licensing income reduced by royalty payments to the CV; (iii) there is no Dutch withholding on royalties under domestic law; (iv) the CV is treated as a pass-through for Dutch purposes and thus is not subject to Dutch tax; and (v) the US parent achieves deferral of US tax on its non-US profits as a result of the CV/SCS’s hybrid treatment. On the one hand, the United States treats the CV/SCS as a corporation and, as a consequence, income that it earns will not generally be subject to current US tax. Moreover, even if the CV/SCS is treated as a CFC, interest and royalty income earned from the BV/Sari, which otherwise would qualify as Subpart F income, may nonetheless not be subject to current US taxation as a result of either § 954(c)(3) or § 954(c)(6). On the other hand, payments to the CV/SCS are also generally not subject to tax in the foreign jurisdiction in which it is established or organized (either Netherlands or Luxembourg) because the foreign jurisdiction views the CV/SCS as a fiscally transparent entity and therefore treats its income as derived by its owners, including its US owners.
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It should be noted that as from 1 January 2020, the benefit of tax deferral for US MNEs derived from setting up those structures in Netherlands or Luxembourg will likely disappear due to the general hybrid mismatch rules of ATADII, whose territorial scope has been extended to third countries. In particular, Article 9(2)(a) of ATADII states that, 'To the extent that a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the Member State that is the payer jurisdiction....'

This means that where the CV/SCS owns IP and licenses such IP back-to-back through the BV/Sarl in exchange for a royalty payment or enters into loan agreements with the BV/Sarl and/or its subsidiaries to lend surplus cash back to group companies, the payments of interest and royalties by the BV/Sarl to the CV/SCS should no longer be deductible. In those cases, indeed, the interest or royalty deduction will be denied in the payer's jurisdiction, i.e., the Netherlands and Luxembourg.

In addition, as mentioned above, ATADII also provides specific rules aimed at reverse hybrid mismatches. Article 9a(1) states that:

Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50 percent or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction.

This specific rule, which takes precedence over the general reverse hybrid mismatch rule of Article 9(2)(a), will become effective as from 1 January 2022. The Netherlands unsuccessfully tried to postpone the effective date to 1 January 2024 'to give third countries, like the United States, sufficient time to amend their legislation to neutralize the effects of a hybrid mismatch in the country of the payment recipient.'

101. See unofficial translation of the assessment by the Dutch government of the proposal of the European Commission regarding hybrid mismatches with third countries, at pp. 4-5: 'An example serves to illustrate this. This is the example of the limited partnership/private limited liability (CV/BV) structure that the Netherlands and the United States (hereinafter: US) regularly include in structures involving head offices resident in the Netherlands. This involves a mismatch with a hybrid entity (a Dutch limited partnership; hereinafter: CV) that the Netherlands regards as transparent and the US, after the taxpayer has elected to be regarded as non-transparent, therefore regards as non-transparent. The US therefore does not tax payments made by a Dutch private limited liability company (hereinafter: BV) to the CV, for example royalty payments for operating intellectual property developed in the US, but does lay a tax claim on this payment at the time the CV distributes the royalties to the parent company established in the US. However, the US does not execute its tax claim for a very long time. The OECD report on Action 2 places the responsibility for eliminating the implications of the hybrid mismatch in this example on the US. Only if the US does not act, is it up to another country, in the present case: the Netherlands, to neutralize the mismatch, or refuse the deduction of the royalty payment from the BV to the CV. This means that the Netherlands would effectively be taxing profit, while the value is created in the US (the intellectual property was, after all, developed there). This is contrary to taxing profit where value is created, which is internationally accepted as the starting point for determining where profit must be taxed. This is an undesirable situation. The Cabinet believes that the country to which a payment is made in such a situation (in the present case: the US), must be given sufficient opportunity in such cases to
Indeed, according to the OECD BEPS Action 2 Report (Recommendation 5), mismatch arrangements can also be addressed through changes to domestic law. The residence state of the foreign investor, in this case, the United States, could improve its CFC regime in order to ensure that income earned by the CV/SCS will be currently subject to US tax. As will be described below, this could be done by closing the two biggest loopholes of the Subpart F regime, namely the same-country exception of § 954(c)(3) and the look-through exception of § 954(c)(6). However, such proposal should consider whether US MNEs will end up being less competitive than foreign multinationals since they will not be able to redeploy their foreign earnings overseas without an additional US tax burden.

Regardless of the actions that have been undertaken by the United States, as a result of Article 9a(1), since the parent company is located in a jurisdiction, the United States, that treats the CV/SCS as a corporation, the CV/SCS would be treated as a Dutch or Luxembourg resident entity and taxed on the interest or royalty income received from the BV/Sarl, respectively.

In this regard, the first question that should be asked is whether rules addressing hybrid mismatches are actually necessary. In the authors’ opinion, the answer to this is theoretically no, but practically yes. Theoretically no because a textual interpretation of Article 24(4) of the Netherlands-United States Income Tax Treaty (1992) suggests that the Netherlands does not have to allow for an exemption from or a reduction of Dutch tax. Article 24(4) of the treaty reads as follows:

> In the case of an item of income, profit or gain derived through a person that is fiscally transparent under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income, profit or gain of a resident.

As mentioned above, the CV is viewed as a pass-through entity for Dutch purposes, but as a company for US tax purposes, when it receives interest or dividends from its operating subsidiary, BV. As a result of this hybrid treatment, income earned by the CV generally would not currently be subject to tax in either the United States or the Netherlands. Consequently, Article 24(4) provides that the withholding rate should not be reduced.102

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102. See http://www.nortonrosefulbright.com/knowledge/publications/154270/holland: “Dividends paid by a Dutch company to someone without the benefit of treaty protection attract a 25% withholding tax. The new protocol to the United States Treaty has a clause that bars treaty benefits in cases where “hybrid” entities are used, like in this case. Even though the Dutch view...
This view was initially also confirmed by J.G. Wine, State Secretary for Finance in a letter of 3 May 2005 to the President of the Senate of the States General, where he argued that the Netherlands was no longer obliged to reduce the withholding rate on dividends and interest paid by the BV to the CV. He justified this result based on the purpose of the hybrid entity provision, according to which differences in the qualification of an entity should not lead to situations of double taxation or double non-taxation. However, in the same letter he also mentioned that he was investigating the possibility of granting certain tax benefits to US MNEs that made use of such structure. If real and substantial activities had been performed in or via the Netherlands, Article 24(4) would not have been applied. Therefore, on 6 July 2005, the State Secretary for Finance published Decree IFZ2005/546M, according to which treaty benefits will be granted to an entity that is classified as transparent for Netherlands tax purposes and as non-transparent for US tax purposes, provided that the Netherlands subsidiary carries out real activities. In this regard, a company may request an advance tax ruling confirming that real activities are carried out. The Decree considered the following points as being relevant for the purposes of determining whether real activities are carried out: (i) whether the dividend distributing company is (for tax purposes only) established in the Netherlands; (ii) whether directors and/or employees are active in the Netherlands; (iii) whether these directors have sufficient professional knowledge; (iv) where important decisions are taken; (v) where the company's primary bank account is kept; (vi) where the bookkeeping takes place; (vii) the amount of equity and debts; (viii) which activities are carried out in or through the Netherlands; (ix) whether the employees active in the Netherlands are sufficiently qualified; (x) where real risks are run and (xi) whether the remuneration for the activities carried out and the risks run is at arm's length. Granting treaty benefits to entities that do not qualify based on the literal interpretation of Article 24(4) is the reason why the present authors believe that hybrid mismatch rules are necessary in practice. In the absence of any tax holiday granted to foreign direct investors, Article 24(4) is perfectly adequate since it provides that dividend withholding tax should not be reduced. Indeed, similar provisions to Article 24(4) have been included in the treaties with Canada, Denmark, France, a dividend paid by the BV as received in the United States directly, the protocol rules out treaty benefits. The protocol language is intended to prevent governments from being whipsawed by clever tax planning’ (accessed 5 Apr. 2018).

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103. See https://zoek.officielebekendmakingen.nl/dossier/29632/kst-20042005-29632-B-h1?result
104. The Netherlands; United States-Netherlands Decree on application of Netherlands-United
108. Article (7) of the Proposed Protocol to the Income Tax Treaty Between the United States and
109. See also Explanation of the Proposed Protocol to the Income Tax Treaty Between the United States and
110. See also Explanation of the Proposed Protocol to the Income Tax Treaty Between the United States and
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Iceland,\textsuperscript{108} Ireland,\textsuperscript{109} Italy,\textsuperscript{110} South Africa,\textsuperscript{111} Thailand\textsuperscript{112} and Venezuela.\textsuperscript{113} In particular, examples in the Technical Explanation address the issue of reverse hybrid entities. The language contained in the Technical Explanation to Article IV(7)(a) of the Canada-United States Income and Capital Tax Treaty (1980) is very clear:

For example, assume USCo, a company resident in the United States, is a part owner of CanLP, an entity that is considered fiscally transparent for Canadian tax purposes, but is not considered fiscally transparent for U.S. tax purposes. CanLP receives a dividend from a Canadian company in which it owns stock. Under Canadian tax law USCo is viewed as deriving a Canadian-source dividend through CanLP. For U.S. tax purposes, CanLP, and not USCo, is viewed as deriving the dividend. Because the treatment of the dividend under U.S. tax law in this case is not the same as the treatment under U.S. law if USCo derived the dividend directly, subparagraph 7(a) provides that USCo will not be considered as having derived the dividend.\textsuperscript{114}

Canada is therefore not obliged to grant treaty benefits, e.g., reduction or elimination of dividend withholding tax imposed under domestic law. Here, the taxable event is the distributive share of dividend paid to CanLP. Because the distributive share of dividend income is not taxed in the United States, there is no reduction in Canadian withholding tax on the share belonging to USCo.

The second question that should be asked is what would be the interaction between US tax reform and ATADII? In particular, what would be the effect of the new GILTI regime on the CV/BV reverse hybrid structure? Would the hybrid mismatches be shut down? Some practitioners have pointed out that since there will be a 10.5\% immediate tax, it could be argued that the United States has resolved the issue of stateless income made possible by the CV/BV structure. In their opinion, due to GILTI, the United States no longer allows profits from IP, such as royalty fees, to be transferred

\textsuperscript{114} Can. \textit{US Income and Capital Tax Treaty – Technical Explanation to the 2007 Protocol} (2007). Similar language is contained in Den. \textit{US Income Tax Treaty – Technical Explanation to the 1999 Treaty} (1999): ‘For example, income from sources in Denmark received by an entity organized under the laws of Denmark, which is treated for U.S. tax purposes as a corporation and is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the other State, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by an entity resident in Denmark.’

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out of a Netherlands-based entity without being taxed anywhere. Only time will tell if that is true, but, in that event, EU Member States should refrain from taxing those profits through either the denial of deduction or by including the payments in the taxable income of the reverse hybrid.

In conclusion, it should be noted that all these problems, especially avoiding taxation by other countries of what the United States believes is its income, would have been resolved if TRA17 had adopted a similar provision to that proposed by the Obama Administration, according to which § 954(c)(3) and § 954(c)(6) would not have been applied to payments made to a foreign reverse hybrid held by one or more US persons when such amounts were treated as deductible payments received from foreign related persons. Indeed, as a consequence of that proposal, the IP income of a CV would currently be subject to US tax. However, the proposal would have modified some of the core provisions of the Subpart F regime denying the possibility for US MNEs to engage in foreign-to-foreign profit shifting. When the US Congress, on behalf of US multinationals, forced Treasury to withdraw Notice 98-11, 1998-1 C.B. it used two arguments to justify foreign-to-foreign profit shifting. First, it was said that reduction of foreign taxes through hybrid entities is a good thing for the US Treasury because if US MNEs pay less tax to foreign administrations, that means they will pay more tax to the United States when earnings are eventually repatriated. Second, foreign-to-foreign profit shifting is also good economically because US MNEs will have at their disposal more resources that could be used to expand their domestic business operations, thereby increasing the well-being of US workers and customers. It is therefore clear why TRA17 did not include the Obama Administration’s proposal. In the authors’ opinion, the United States finds itself confronted by a difficult choice: (i) either tax MNEs’ offshore income now by eliminating deferral or (ii) do nothing and risk that other countries, such as EU Member States through ATAD II, might tax what the United States believes is its tax base. Basically, it is like a zero-sum game; if US tax authorities gain, US multinationals lose and vice-versa.

§1.07 CONCLUSION: THE FUTURE OF BEPS

The authors believe that with TRA17, the future of BEPS as the underlying standard of the international tax regime (ITR) is assured. As long as the United States stood aside, it was not clear that the European Union would be able to implement BEPS on its own,

116. See General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals, Department of the Treasury (Feb. 2016), at p. 26. The proposal is substantially similar to a proposal found in the President’s fiscal year 2015 budget proposal, except that it now describes the foreign reverse hybrid subject to the proposal as owned by one or more US persons, rather than a hybrid held directly by a US owner, which could have been interpreted to limit the proposed rule to hybrids with only one owner. For a description of that proposal, see Joint Committee on Taxation, Description of Certain Revenue Provisions Contained in the President’s Fiscal Year 2015 Budget Proposal (JCS-2-14) (Dec. 2014), pp. 58–66.
and China is only now just beginning to adopt BEPS measures. But TRA17 represents the incorporation of BEPS into US domestic tax law. Moreover, TRA17 should not be considered as a 'tax war': it is a long-overdue response to the BEPS by US and other multinationals and a correct application of the single tax principle to prevent double non-taxation. It turns out that the immense effort of the OECD in 2013–2015 was not in vain and a new and better ITR is on the horizon.