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

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

Reuven Avi-Yonah\* & Gianluca Mazzoni\*\*

### I INTRODUCTION: THE US AND BEPS

Since its launch in 2013, the US 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<sup>1</sup> the US is stepping back from the BEPS process. While the EU was charging ahead with implementing BEPS

through the Anti-Tax Avoidance Directive (ATAD), the US stated that it was already in compliance with all BEPS minimum standards and therefore other than Country-by-Country Reporting (CbCR) it had no further BEPS obligations. The US decided not to sign the Multilateral Instrument (MLI) to implement BEPS into tax treaties,<sup>2</sup> and did not join the Common Reporting Standard (CRS) to further automatic exchange of information,<sup>3</sup> leading the EU to call it a tax haven.<sup>4</sup> The US did adopt BEPS provisions in its model tax treaty,<sup>5</sup> but those have not

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<sup>1</sup> Early commentators argued that the OECD has good reason to be pessimistic about BEPS's project success under the new US administration primarily due to little enthusiasm showed by previous Republican administrations in prioritizing the fight against international tax avoidance and evasion, such as 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?* 86 *Tax Notes Int'l* 617 (15 May 2017). That view has been recently upheld by a panel of experts, during the EU-US Tax regulation forum: contest or dialogue organized by Ludovici & Partners, according to which the path taken by US Congress last Dec. is inconsistent with the BEPS project ... which US declined to sign last June because, as Ludovici stated, 'BEPS project has an anti-avoidance function, while Bear is entirely designed and focused on US.' Unofficial authors' translation of A. Galimberti, *Con Bear e Gilti il fisco Usa torna indietro di 17 anni*, *IL SOLE* 24 ORE (14 Mar. 2018).

<sup>2</sup> According to Henry Louie, deputy international tax counsel at the US Treasury Department, the US 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 Treasury Department's longstanding policy, i.e. rules that determine when treaty benefits should be available for payments through fiscally transparent entities Art. 1(6) of the US Model Income Tax Convention (2016); robust bright-line objective LOB rules that prevent third-country investors from routing their investment into the US through a company resident in a treaty partner to get treaty benefits. Henry 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 US' refusal to sign on to the MLI. See K. A. Bell, *Treasury Official Explains Why US Didn't Sign OECD Super-Treaty*, BNA Transfer Pricing Report (8 June 2017), <https://www.bna.com/treasury-official-explains-n73014453413/> (accessed 5 Apr. 2018).

<sup>3</sup> Because it has signed a host of bilateral intergovernmental agreements (IGAs), US sees no need to join the CRS. See *The Economist*, *The biggest loophole of all* (20 Feb. 2016), <https://www.economist.com/news/international/21693219-having-launched-and-led-battle-against-offshore-tax-evasion-america-now-part> (accessed 5 Apr. 2018).

<sup>4</sup> Financial Times, K. Scannell & V. Houlder, *US tax havens: The new Switzerland* (8 May 2016), <https://www.ft.com/content/cc46c644-12dd-11e6-839f-2922947098f0> (accessed 5 Apr. 2018). For a general comment on the topic of automatic exchange of information (AEOI) see G. Marino, *International and European Measures for De-offshoring: Global Ambitions and 2017 Local Hypocrisies*, 45(8/9) *Intertax* at 527 et seq. However, it should be noted that on 13 Dec. 2016 the US 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. In the authors' opinion, re-AEOI this should give the US something to exchange.

<sup>5</sup> 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 Art. 16(4) of the tax treaty with Austria (1996), Art. 21(6) of the tax treaty with Belgium (2006), Art. 22(6) of the tax treaty with Denmark (1999), Art. 16(5) of the tax treaty with Finland (1989), Art. 30(5) of the tax treaty with France (1994), Art. 28(5) of the tax treaty with Germany (1989), Art. 21(5) of the tax treaty with Iceland (2007), Art. 23(7) of the tax treaty with Ireland (1997), Art. 24(5) of the tax treaty with Luxembourg (1996), Art. 22(5) of the tax treaty with Malta (2008), Arts 1 and 2 of 1993 Protocol of the tax treaty with the Netherlands (1992), Art. 22(6) of the tax treaty with South Africa (1997), Art. 17(5) of the tax treaty with Sweden (1994), and Art. 22(4) of the tax treaty with Switzerland (1996); new language added to Arts 10(5), 11(2)(d), 12(2)(b), 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), 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*, University of Michigan Public Law Research Paper No. 480, 1 *Global Tax'n* 12 (2016). See also M. Herzfeld, *US Perspectives on the Multilateral Instrument*, 46(1) *Intertax* at 80 et seq. (2018). In addition to these new provisions, the US Model Income Tax Convention (2016) incorporates certain other BEPS recommendations for the first time: 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; a rule intended to prevent contract-splitting to circumvent the twelve-month threshold for building sites or construction or installation projects (Art. 5(3)); 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 Final Report on Action 7 proposed amendments to Arts 5(5) and 5(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 US has not seen promised guidance on attribution of profits to permanent establishments and is not

been implemented in any actual US treaty.<sup>6</sup> Thus, most observers believe that the US has abandoned the BEPS effort.

But this view is partially wrong. The current tax reform legislation clearly relies on BEPS principles and in particular on the single tax principle. This represents a triumph for the G20/OECD and is incongruent with the generally held view that the US will never adopt BEPS.

This Article proceeds in four parts. Part II will 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 section 965); and two anti-base erosion and income shifting provisions, namely a foreign minimum tax on 10% US shareholders of CFCs to the extent the CFCs are treated as having ‘global intangible low-taxed income’ (GILTI) (new section 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 section 59A). Part III will discuss one of the key BEPS action items that caused the most concern in the US, i.e. action 6 on the prevention of treaty abuse through inclusion of a *principal purposes* test. In part IV, authors will argue that Congress could have done more, especially with regard to the anti-hybrid rules for certain related party amounts of new section 267A since it does not have any significant 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*, Obama administration proposed a rule that would provide that sections 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. Parts IV concludes.

## 2 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<sup>7</sup> and illiquid assets taxed at an 8% effective rate.<sup>8</sup> Taxpayer may elect to pay this tax over an eight-year period.<sup>9</sup> However, if a US shareholder becomes an ‘*expatriated entity*’ within the meaning of section 7874(a)(2)<sup>10</sup> 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.<sup>11</sup>

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.<sup>12</sup> Indeed, these earnings, accumulated since the 2004–2005 tax amnesty, currently exceed USD 2.6 trillion, they are located in just seven low tax jurisdictions,<sup>13</sup> and they are highly concentrated: just four companies (Apple,<sup>14</sup> Microsoft,<sup>15</sup>

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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 at 1029 et seq. (19 June 2017).

<sup>6</sup> However, see US Department of the Treasury Office of Tax Policy, bilateral tax treaty negotiations between the United States and Luxembourg (22 June 2016), <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Luxembourg-Statement-06222016.pdf> (accessed 5 Apr. 2018). For a comment see E. Tanenbaum, *The 2016 US Model Income Tax Treaty in Action: US-Luxembourg Protocol*, BNA Int’l Tax (9 Sept. 2016), <https://www.bna.com/2016-us-model-n73014447419/> (accessed 5 Apr. 2018).

<sup>7</sup> Fourteen per cent in the House bill s. 4004 and 14.5% in the Senate amendment s. 14103.

<sup>8</sup> Seven per cent in the House bill s. 4004 and 7.5% in the Senate amendment s. 14103.

<sup>9</sup> S. 965(h)(1) of TRA17.

<sup>10</sup> 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. Y. Marian, *Home Country Effects of Corporate Inversions*, 90 Wash. L. Rev. 1, 7–9 (2015).

<sup>11</sup> S. 965(l)(1).

<sup>12</sup> OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (OECD Publishing 2018).

<sup>13</sup> Clausing suggests that 82% of US profit shifting problem is with just seven tax havens with extremely low effective tax rates: Netherlands, Ireland, Luxembourg, Bermuda, Switzerland, Singapore, and the UK Caribbean Islands. These countries alone account for 50% of all foreign income earned by affiliates of US multinational firms, but they only account for 5% of all foreign employment of such firms. See K. A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, 69 Nat’l Tax J. 4 (2016). See also M. P. Keightley & J. M. Stupak, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data*, CRS report R44013 (30 Apr. 2015), at 6; G. Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. Econ. Persps. 4, 128 (2014).

<sup>14</sup> Apple Inc. I 2017 Form 10-K at 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 US dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to US income taxation on repatriation to the US.’ <http://files.shareholder.com/downloads/AAPL/6134806168x0x320193-17-70/320193/filing.pdf> (accessed 5 Apr. 2018).

<sup>15</sup> Microsoft Corp I 2017 Form 10-K (Annual Report): ‘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 US government and agency securities, approximately 3% were invested in US mortgage- and asset-backed securities, and approximately 2% were invested in corporate notes and bonds of US companies, all of which are denominated in US dollars. The remaining cash

Pfizer,<sup>16</sup> and GE<sup>17</sup>) hold approximately one-quarter (24%) of the offshore profits. Ten companies have 38% of the profits, and 50 companies hold three-quarters of the earnings.

In the authors' opinion, there are four arguments why such low rates are inappropriate for past earnings.

Firstly, 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 happened) and because they mostly represent earnings on intellectual property developed in the United States with hefty taxpayer support.<sup>18</sup>

Secondly, there are a few outstanding issues with dual rates, including: (1) what may be considered a 'cash or cash equivalent' for the purposes of this tax; and (2) 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.<sup>19</sup> The new law includes both a look-back rule and a subjective intent-based anti-abuse test, the so-called *a principal purposes* test. Indeed, section 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 1 January 2018, or the average of the cash position determined on the last day of each of the two taxable years ending immediately before 2 November

2017.' In addition, section 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.' 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,' 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, then authors believe that the effectiveness of section 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 antiabuse 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. *Any such claim would have to satisfy a much lower threshold of 'believability'* if the test were whether 'the' principal purpose of the transaction is tax avoidance ... The history of section 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 USD 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

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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).

<sup>16</sup> Pfizer Inc. I 2016 Form 10-K at 95: 'As of December 31, 2016, we have not made a US 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://d18rn0p25nwr6d.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 US 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 installment due in April 2019].' See 2017 Financial Report at 57, [https://s21.q4cdn.com/317678438/files/doc\\_financials/Annual/2017/Financial-Report-2017.pdf](https://s21.q4cdn.com/317678438/files/doc_financials/Annual/2017/Financial-Report-2017.pdf) (accessed 5 Apr. 2018).

<sup>17</sup> GE 2016 FORM 10-K at 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 US operations. Because of the availability of US foreign tax credits, it is not practicable to determine the US 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](https://www.ge.com/ar2016/assets/pdf/GE_AR16.pdf) (accessed 5 Apr. 2018). In its 2017 FORM 10-K, at 21 GE stated that, 'On December 22, 2017, the US enacted the Tax Cuts and Jobs Act (US tax reform) that lowers the statutory tax rate on US 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 US 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> (accessed 5 Apr. 2018).

<sup>18</sup> According to the Permanent Subcommittee on Investigations (PSI) report on Offshore Profit Shifting and the US 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.

<sup>19</sup> S. E. Shay, *Directions for International Tax Reform*, Testimony before the US Senate Committee on Finance, Hearing on International Tax Reform (3 Oct. 2017), <https://www.finance.senate.gov/imo/media/doc/Shay%2010-3-17%20SEC%20Testimony%20final%209-30.pdf> (accessed 5 Apr. 2018); S. E. Shay, *Tax Reform – Process Failures, Loopholes and Wealth Windfalls* (21 Nov. 2017), <https://dash.harvard.edu/handle/1/34377640> (accessed 5 Apr. 2018); D. Morgan, *Corporations may dodge billions in US taxes through new loophole – experts*, Reuters Market News (12 Jan. 2018), <https://www.reuters.com/article/usa-tax-repatriation/rpt-corporations-may-dodge-billions-in-u-s-taxes-through-new-loophole-experts-idUSL1N1P701I> (accessed 5 Apr. 2018).

to section 269s 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*.<sup>20</sup>

Thirdly, 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,<sup>21</sup> 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 spending that money, and they’ll be spending that money right here. And it will be jobs and lots of other good things.*<sup>22</sup>

Thus, it is highly likely that repatriated funds will be used for already planned projects, such as pay down existing borrowings,<sup>23</sup> set off a new wave of M&A,<sup>24</sup> 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.<sup>25</sup> On the other hand, Apple announced in January that it would invest USD 30 billion in capital spending in the US over five years that would create more than 20,000 jobs. However, analysts questioned whether Apple’s commitments were new and impacted in any way by tax reform since it could deliver on those with existing cash flow – without needing to tap cash holdings.<sup>26</sup>

Last but not least, this money is not trapped offshore. Under previous section 956(c)(2)(A) and (F), a foreign

subsidiary’s untaxed earnings might have been invested without triggering the deemed dividend rules in stock of a domestic corporation, a debt obligation of a US person, or a US bank deposit, as long as the issuer is not a US shareholder or does not have a 25%nt or other proscribed relationship with the foreign subsidiary.<sup>27</sup> The US Senate Permanent Subcommittee on Investigations on the 2004 tax holiday has showed that of USD 538 billion in undistributed accumulated foreign earnings at the end of FY2010 at 20 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.<sup>28</sup> Recent data compiled by Bloomberg show that the top 10 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.<sup>29</sup>

### 3 FUTURE ACCUMULATIONS

In TRA17, the shift from a world-wide 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 new section 951A(a), a US shareholder of any CFC must include in gross income for a taxable year its GILTI in a manner generally similar to inclusions of subpart F income. GILTI means, with respect to any 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.<sup>30</sup> Net deemed

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- <sup>20</sup> 94 TNT 130-34 NYSBA Submits Report on Partnership Antiabuse Regulation, 1 July 1994 (Doc 94-6234).
- <sup>21</sup> K. A. Clausing, *Profit shifting and US corporate tax policy reform*, Washington Center for Equitable Growth (10 May 2016), at 10: ‘As part of the American Jobs Creation Act of 2004, the US government gave US multinational firms a temporary holiday for repatriating income at a low rate of 5.25%. 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.’ <http://cdn.equitablegrowth.org/wp-content/uploads/2016/05/05115111/051016-clausing-profit-shifting.pdf> (accessed 5 Apr. 2018).
- <sup>22</sup> Cabinet Room, *Remarks by President Trump at Lunch with Bicameral Tax Conferees – Budget & Spending* (13 Dec. 2017), <https://www.whitehouse.gov/briefings-statements/remarks-president-trump-lunch-bicameral-tax-conferees/> (accessed 5 Apr. 2018).
- <sup>23</sup> R. Waters, *US tax holiday will benefit tech shareholders not workers*, Financial Times (27 Apr. 2017), <https://www.ft.com/content/1ede0082-2b5d-11e7-bc4b-5528796fe35c> (accessed 5 Apr. 2018).
- <sup>24</sup> C. Nao, *Trump’s Corporate Tax Reform Poised to Fuel More M&A*, LAW 360 (28 Apr. 2017): ‘We would expect to see an increase in domestic acquisitions by US 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% would allow companies, instead of having to borrow, to access that cash to make domestic acquisitions ...’ <https://www.law360.com/tax/articles/918368/trump-s-corporate-tax-reform-poised-to-fuel-more-m-a> (accessed 5 Apr. 2018).
- <sup>25</sup> A. Hufford & J. Greene, *Cisco to Bring USD 67 Billion to US After New Tax Law*, Wall St. J. (14 Feb. 2018), <https://www.wsj.com/articles/cisco-returns-to-growth-after-two-year-sales-slump-1518645580?mod=searchresults&page=1&pos=2> (accessed 5 Apr. 2018).
- <sup>26</sup> Tripp Mickle, *Apple to Pay USD 38 Billion in Taxes on Cash Overseas, Build New US Campus*, Wall St. J. (17 Jan. 2018), <https://www.wsj.com/articles/apple-to-pay-38-billion-in-repatriation-tax-plans-new-u-s-campus-1516215419> (accessed 5 Apr. 2018).
- <sup>27</sup> S. E. Shay, *The Truthiness of ‘Lockout’: A Review of What We Know*, 146 Tax Notes 9 (16 Mar. 2015), at 1394 footnote no. 7.
- <sup>28</sup> United States Senate, Permanent Subcommittee on Investigations, C. Levin (D-MI) & J. McCain (R-AZ), *Memorandum RE Offshore Profit Shifting and the US Tax Code – Part 2 (Apple Inc.)* (21 May 2013), at 7 footnote no. 13.
- <sup>29</sup> A. Wong, *Americans Are Paying Apple Millions to Shelter Overseas Profits*, Bloomberg Technology (7 Dec. 2016), <https://www.bloomberg.com/graphics/2016-apple-profits/#methodology> (accessed 5 Apr. 2018).
- <sup>30</sup> S. 951A(b)(1) of TRA17.

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 expense that is taken into account in determining its net CFC tested income.<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup> 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 section 167.<sup>34</sup> To put it simply, the formula for GILTI can be expressed as:

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

As a result, GILTI's 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.<sup>35</sup>

The tax rate of future GILTI is determined by taking the 21% corporate tax rate and allowing a deduction of 50%,<sup>36</sup> for a net rate of 10.5%.<sup>37</sup> This rate can be partially offset by foreign tax credits,<sup>38</sup> but in a separate basket<sup>39</sup> (but with cross-averaging within the basket).<sup>40</sup> 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 basis in offshore tangible assets, which is zero or close to it (since they derive almost all of their income from intangibles). Other MNEs (e.g. GE or Intel) will pay less because they have more tangible assets offshore. This creates an obvious incentive to move jobs (not just profits) offshore. In this regard, a Baker McKenzie Client Alert observed that,

the GILTI rules create a surprising and unexpected incentive for US multinationals to increase the

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<sup>31</sup> S. 951A(b)(2) of TRA17.

<sup>32</sup> S. 951A(c)(1) of TRA17.

<sup>33</sup> S. 951A(c)(2) of TRA17.

<sup>34</sup> S. 951A(d)(1) of TRA17.

<sup>35</sup> M. A. Sullivan, *Economic Analysis: More Gilti Than You Thought*, 89 Tax Notes Int'l 587 (12 Feb. 2018): 'GILTI is an arbitrary measure of high profitability. High profits (relative to tangible assets) 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 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 ss 951A and 250. And, as we shall see, the "LI" is also misleading because in certain circumstances, GILTI can be subject to US tax even when the average worldwide foreign tax rate of a US taxpayer is not low'; C. H. Lowell, M. P. Thomas & K. L. Novak, *The International Provisions of the TCJA*, J. Corp. Tax'n (WG&L) (Mar./Apr. 2018): 'The Final BEPS Actions 8–10 recommendations focused on establishing an appropriate balance in the allocation of income between routine and non-routine functions of affiliates. The US approach embraces this model to (1) coordinate its new territorial regime with the former worldwide regime, including prior tax base protection mechanisms in the CFC and related FTC provisions of the US Code; and (2) encourage economic activity within the United States. For these purposes, such non-routine income is derived by defining "intangible income" as the margin in excess of a normative return of 10% on tangible assets'; L. D. Yoder, D. G. Noren & E. R. Chao, *Tax Reform: Taxation of Income of Controlled Foreign Corporations*, BNA Daily Tax Report (22 Jan. 2018): 'In general, the new GILTI provision is designed to impose a minimum residual US 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").'

<sup>36</sup> S. 250(a)(1)(B) of TRA17. For taxable years beginning after 31 Dec. 2025, the deduction for GILTI is lowered to 37.5%, see S. 250(a)(3)(B). It should be noted that the conference agreement followed s. 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 (s. 1363(b)) so that deductions allowable only to corporations, such as FDII and GILTI, do not apply. See House of Representatives, Tax Cuts and Jobs Act, Conference Report to accompany H.R. 1 (15 Dec. 2017), footnote 1524, also known as 'Conference Report to TRA17'. For a comment see L. Browning, 'Orwellian' Offshore Tax Will Hit Some Firms Harder Than Others, Tax Management Weekly Report (1 Jan. 2018): 'But those low rates are available only for corporations. Partnerships and other so-called pass-through entities would face much higher rates on some of their foreign income – they wouldn't get the deduction, experts say ... global private equity partnerships that aren't publicly traded wouldn't be eligible for the GILTI deduction.'

<sup>37</sup> The Conference Report to TRA17, *supra* n. 36, fn. 1527 illustrates that, 'If the foreign tax rate on GILTI is zero percent, then the US residual tax rate on GILTI is 10.5%. Therefore, as foreign tax rates on GILTI range between zero percent and 13.125%, the total combined foreign and US tax rate on GILTI ranges between 10.5% and 13.125%. At foreign tax rates greater than or equal to 13.125%, there is no residual US tax owed on GILTI, so that the combined foreign and US tax rate on GILTI equals the foreign tax rate.'

<sup>38</sup> S. 960(d)(1) of TRA17.

<sup>39</sup> S. 904(d)(1)(A) of TRA17.

<sup>40</sup> L. D. Yoder, D. G. Noren & E. R. Chao, *supra* n. 35: 'A foreign tax credit is permitted for 80% of the foreign taxes associated with GILTI ... A separate basket is provided for non-passive GILTI taxes, and any excess credits may not be carried forward or back (i.e. the computation is carried out on a purely annual basis). It appears that the US tax consequences are calculated by treating all non-passive GILTI the same. This allows for cross-crediting between non-passive GILTI that is subject to tax at different rates, but taxes associated with non-passive GILTI may not be used to offset income in other baskets.'

amount of tangible assets held by their CFCs, which in most circumstances will be 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.<sup>41</sup>

To address these issues, TRA17 proposes two solutions. Firstly, section 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. Secondly, section 250(a)(1)(A) provides a 37.5% foreign-derived intangible income deduction (FDII),<sup>42</sup> 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 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<sup>43</sup> over its deemed tangible income return.<sup>44</sup>

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.<sup>45</sup> Foreign use means any use, consumption, or disposition which is not within the United States.<sup>46</sup> For purposes of the provision, the term '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. Sections 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.<sup>47</sup> Transactions implicating this rule might arise where, e.g. a US corporate taxpayer who owns IP rights domestically in film or television programming licenses those rights to a wholly-owned foreign subsidiary, which, in turns, sub-licenses the content in its local market to third parties.<sup>48</sup> 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 taxpayer establishes to the satisfaction of the Secretary that such service is not substantially similar to services provided by the related party to persons located within the United States.<sup>49</sup>

There are three obvious problems with the FDII deduction.

According to a group of 13 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

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<sup>41</sup> Baker McKenzie, Tax News and Developments – Client Alert, *The Tax Cuts and Jobs Act: Congress Passes A Major Tax Bill For First time in Thirty Years* (20 Dec. 2017), at 21, <https://www.bakermckenzie.com/-/media/files/insight/publications/2017/12/client-alert-us-tax-reform-the-tax-cuts-and-jobs-act-congress-passe.pdf?la=en> (accessed 5 Apr. 2018).

<sup>42</sup> S. 250(a)(3)(A) of TRA17. For taxable years beginning after 31 Dec. 2025, the deduction for FDII is reduced to 21.875%.

<sup>43</sup> S. 250(b)(3)(A) of TRA17. 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.

<sup>44</sup> S. 250(b)(2)(B) of TRA17. 10% of the corporation's QBAI; Baker McKenzie, *supra* n. 41, at 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.'

<sup>45</sup> S. 250(b)(4) of TRA17.

<sup>46</sup> S. 250(b)(5)(A) of TRA17.

<sup>47</sup> S. 250(b)(5)(C)(i) of TRA17.

<sup>48</sup> M. H. Salama, *Film and TV Production: Tax Accounting Considerations and Federal Tax Incentives, Detailed Analysis* (Tax Management Inc. 2012).

<sup>49</sup> S. 250(b)(5)(C)(ii) of TRA17.

'roundtripping' transactions in regulations with rules similar to those under Treas. Reg. 1.954-3(a)(3)(ii),<sup>50</sup> which determine the place of use, consumption, or disposition of property for foreign base company sales income purposes. In particular, Treasury should require US manufactures to conduct a real investigation of how much the independent foreign party will sell back into the United States.<sup>51</sup> 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 property sold is somewhat further processed abroad,<sup>52</sup> 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 not qualify as foreign-derived deduction eligible income since software was just merely imprinted in physical form and not significantly modified.

Secondly, 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 US other than exporting. Taxpayers can get the lower rate by importing goods and immediately exporting them.<sup>53</sup> As stated by Michael L. Schler, 'the provision does not require that anything be manufactured in the US The formula is based only on profits from exports. A US 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.'<sup>54</sup>

Thirdly, the FDII regime has a blatant and obvious WTO problem:<sup>55</sup> 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 US to repeal the subsidy and enact a domestic manufacturing provision (section 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 US during the US-FSC litigation. The authors would expect that this provision will be struck down by the WTO, and the US 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 the GILTI rate as the same as the domestic rate (21%).<sup>56</sup>

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<sup>50</sup> Treas. Reg. S. 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.'*

<sup>51</sup> D. Kamin, D. Gamage et al., *The Games They Will Play: An Update of the Conference Committee Tax Bill* (18 Dec. 2017), <https://ssrn.com/abstract=3089423> (accessed 5 Apr. 2018).

<sup>52</sup> Conference Report to TRA17 *supra* n. 36, at 625, fn. 1522: 'If property is sold by a taxpayer to a person who is not a US 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.' For a comment see D. Kamin, D. Gamage et al., *supra* n. 51, footnote 41 at 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.'

<sup>53</sup> In addition, in their letter sent to Treasury Secretary Mnuchin, the Finance Ministers of France, Germany, Italy, Spain and United Kingdom noted that: '[t]he 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.' See letter (2017-99739) from Peter Altmaier et al. to Steven Mnuchin (11 Dec. 2017); see also C. Brandon Elliot, *The Senate Bill and the WTO: Is the U.S. Headed for Another 35 Years' War?* Tax Notes Int'l 1011 (11 Dec. 2017).

<sup>54</sup> M. L. Schler, *Reflections on the Pending Tax Cut and Jobs Act*, Tax Forum No. 686 (4 Dec. 2017), at 41.

<sup>55</sup> R. Kysar, *The Senate Tax Plan Has a WTO Problem*, Medium (22 Nov. 2017), <https://medium.com/whatever-source-derived/the-senate-tax-plan-has-a-wto-problem-guest-post-by-rebecca-kysar-31deee86eb99> (accessed 5 Apr. 2018); D. Kamin, D. Gamage et al., *supra* n. 51, at 20; R. S. Avi-Yonah & M. Vallespinos, *The Elephant Always Forgets: US Tax Reform and the WTO* U of Michigan Law & Econ Research Paper No. 18-006 (28 Jan. 2018).

<sup>56</sup> In this regard, it should be noted that on 1 Mar. Rep. Rosa L. DeLauro (D-Conn.) has introduced legislation (H.R. 5145) to amend the Internal Revenue Code 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 House of Representatives, H.R. 5145, to amend the Internal Revenue Code 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 (1 Mar. 2018).



## 4 BASE EROSION

The Conference Agreement followed the Senate's Base Erosion and Anti-Abuse Tax (BEAT) with some changes,<sup>57</sup> an alternative to the House excise tax proposal.<sup>58</sup> Under new section 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%.<sup>59</sup> 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 section 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) section 38 credit properly allocable to the section 41(a) research credit; plus (2) the portion of the applicable section 38 credits not in excess of 80% of the lesser of the amount of such credits or the base erosion minimum tax amount.<sup>60</sup> 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.<sup>61</sup> 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,<sup>62</sup> 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);<sup>63</sup> premiums or other consideration paid or accrued for any reinsurance payments<sup>64</sup> and, only

for inverted corporations, also cost of goods sold (COGS).<sup>65</sup> On the other hand, payments for services if such services qualify for the services cost method under Treas. Reg. section 1.482-9 and only if are made for services that have no markup component,<sup>66</sup> as well as any qualified derivative payment, are not treated as base erosion payments.<sup>67</sup>

A couple of preliminary observations are in order. Firstly, the real purpose of BEAT seems to be somehow ambiguous and confounding. If BEAT intends to prevent the erosion of and protect US tax base, why making a distinction between payments to foreign related parties and payments to unrelated ones, and including only the former in calculating the new tax? Stevens and Barnes argued that the definition of base erosion payment apparently reflects US government's lack of confidence in policing transfer pricing.<sup>68</sup> In this regard, it should be noted that section 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<sup>69</sup> may be applied to identify whether a foreign related party is the actual beneficial owner of a base erosion payment.

Secondly, it offers tax planning opportunities with unintended consequences. Rather than manufacturing

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<sup>57</sup> S. 14401 of the Senate amendment.

<sup>58</sup> S. 4303 of the House bill.

<sup>59</sup> S. 59A(e)(1) of TRA17. In the case of banks and registered securities dealers, the base erosion percentage is 2%, see s. 59A(e)(1)(C) of TRA17.

<sup>60</sup> S. 59A(b)(1) of TRA17.

<sup>61</sup> S. 59A(c)(1) of TRA17.

<sup>62</sup> S. 59A(d)(1) of TRA17.

<sup>63</sup> S. 59A(d)(2) of TRA17.

<sup>64</sup> S. 59A(d)(3) of TRA17.

<sup>65</sup> S. 59A(d)(4)(A) of TRA17.

<sup>66</sup> S. 59A(d)(5) of TRA17. For a comment see B. Wells, *Get With the BEAT*, 158 Tax Notes 8, 1027 (19 Feb. 2018): 'Under the facts in Example 2, the BEAT still does not apply. In this regard, related-party tax deductible payments that reimburse the foreign parent corporation for the actual cost of such related-party services are excluded from the definition of a base erosion payment for purposes of computing modified taxable income under s. 59A. If Example 2 involved both a cost reimbursement and a markup as part of the service cost reimbursement, a colloquy between Senate Finance Committee Chair Orrin G. Hatch, R-Utah, and Finance Committee member Rob Portman, R-Ohio, suggests that only the portion of the service fee related to the markup (not the gross amount of the service payment) would be considered a base erosion payment under s. 59A(c)(2). However, the language in the Senate bill that was the subject of this colloquy provided that the service cost "constitutes the total service cost with no markup." But, the final bill modified that language to state that the service cost exception applies only if the service costs "constitutes total service cost with no markup component." Thus, if the facts in Example 2 were changed so that a payment representing a markup component were made in any form in addition to the service cost payment, then the total amount of the service payment would be considered a base erosion payment, whereas a recharge of services at cost would not.'

<sup>67</sup> S. 59A(h)(1) of TRA17.

<sup>68</sup> E. J. Stevens & P. A. Barnes, *INSIGHT: BEAT Strikes the Wrong Note*, 53 BNA Daily Tax Report 16, 2 (19 Mar. 2018): 'The only sustainable argument for the BEAT tax is that US transfer pricing enforcement is so wholly ineffectual that it must be backstopped by an automatic penalty on most cross-border related party transactions and a crude proxy for an arm's length price.' [http://www.cpdale.com/files/22787\\_insight\\_beat\\_strikes\\_thewrong\\_note.pdf](http://www.cpdale.com/files/22787_insight_beat_strikes_thewrong_note.pdf) (accessed 5 Apr. 2018).

<sup>69</sup> Treas. Reg. s. 1.881-3.

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.<sup>70</sup>

Finally, can the BEAT be seen as violating the non-discrimination provision of Article 24?

Article 24 has two relevant provisions. Articles 24(4) and 24(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.*

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 section 163(j)).<sup>71</sup> And thin capitalization rules, even though they do frequently involve denying the interest deduction for interest paid to foreign but not domestic related parties, are widely used and generally regarded by the OECD as non-discriminatory.<sup>72</sup>

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.<sup>73</sup>

Arguably, this paragraph is violated by the BEAT, because a foreign-owned US party will be subject to the BEAT but a US-owned one would not. But there are two counter-arguments. First, the BEAT 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 intent(s) was to protect the US corporate tax base, not to discriminate against foreign-owned US parties.

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

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<sup>70</sup> M. L. Schler, *Reflections on the Pending Tax Cut and Jobs Act*, Tax Forum No. 686, 39–40 (4 Dec. 2017): '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 US corporation to buy finished goods from a foreign affiliate rather than (1) pay the foreign affiliate to act as a contract manufacturer for the US company (a service payment), or (2) manufacture the goods itself and pay the foreign affiliate a royalty for the use of the trademark.' D. Kamin, D. Gamage et al., *supra* n. 51, at 22: 'Royalty payments from a US 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 US affiliate, this could be considered cost of goods sold that is not captured by the inbound regime.' E. J. Stevens & P. A. Barnes, *supra* n. 68, at 2: 'A US company pays royalties to a foreign affiliate (which may be a foreign parent of the US company, or a foreign subsidiary if the taxpayer is a US headquartered company.) The US company uses the intellectual property to manufacture goods in the US (which, significantly, provides US jobs). If the US 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 US 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.' However, Koontz 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 US group member sources inventory for sales to US 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. Koontz & J. M. Kadet, *Internet Platform Companies and Base Erosion – Issue and Solution*, 157 Tax Notes 10 (Dec. 2017).

<sup>71</sup> S. 163(j) was amended in TRA17 to apply a 30% of earnings limit on all business interest, whether paid to domestic or foreign parties.

<sup>72</sup> See OECD, Committee on Fiscal Affairs, *Report on Thin Capitalisation* (OECD Publishing 26 Nov. 1986). There was some diversity of opinion about whether Art. 9 is held to be 'restrictive' or merely 'illustrative' in its scope. Some consider that para. 1 of Art. 9 prohibits an adjustment of the profits of a taxpayer beyond arm's length amounts. Others argued that, while para. 1 of Art. 9 permits the adjustment of profits up to the arm's length amount, it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. Note that in the case of interest, comparables always exist, but IRC 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 163(j) as discriminatory. See H. Ault & J. Sasseville, *Taxation and Non-Discrimination: A Reconsideration*, 2 World Tax J. 2 (2010).

<sup>73</sup> Art. 24(5) of TRA17: '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.'

parties precisely in those jurisdictions that exempt such payment 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 the single tax principle, it is perfectly appropriate for the US to deny a deduction for items that it has no reasons to believe will be taxed on a residence basis. No violation of article 24(5) should arise under those circumstances. Therefore, EU treaty partners rather than engaging in retaliatory actions, should adopt similar measures and apply them to US multinationals.<sup>74</sup>

## 5 BEPS ACTION 6: SHOULD THE US RECONSIDER THE REJECTION OF THE PRINCIPAL PURPOSE TEST?

One of the key BEPS actions that generated the most controversy in the US and eventually led the US not to join the multilateral treaty was Action 6 primarily due to the inclusion of a general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or 'PPT' rule). Under that rule, if *one of the principal purposes* of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

In order to understand why the US opposed such subjective intent-based test, and preferred a more objective detailed Limitation on Benefits provision (LOB), which is 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, therefore was increasingly relying on explicit anti-abuse provisions in its treaties. Indeed, Italian domestic anti-abuse provisions were so weak that, in three cases of early 2000s, tax authorities tried to unsuccessfully fight *dividend washing* transactions<sup>75</sup> 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 similar provision to Article 30 of the 1995 treaty with Israel, which reads as follow:

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, if in their opinion the receipt of those benefits, under the circumstances, would constitute an abuse of the Convention according to its purposes.<sup>76</sup>

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<sup>74</sup> I. Grinberg, *The BEAT is a Pragmatic and Geopolitically Savvy Inbound Base Erosion Rule* (12 Nov. 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3069770](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3069770) (accessed 5 Apr. 2018); B. Wells, *supra* n. 68, at 1030: 'Instead of criticizing the BEAT, the appropriate European 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.' J. Kirwin, *EU Requests OECD Review of US Tax Law's Harmful Provisions*, BNA Int'l Tax (7 Mar. 2018), <https://www.bna.com/eu-requests-oecd-n57982089605/> (accessed 5 Apr. 2018); J. Kirwin, *EU May Blacklist US As a Tax Haven After OECD Review*, BNA Int'l Tax (23 March 2018), <https://www.bna.com/eu-may-blacklist-n57982090327/> (accessed 5 Apr. 2018).

<sup>75</sup> 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 of 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, qualifies for reduced withholding on the dividend income under the United States-Italy income tax treaty. Otherwise, the dividend income would be subject to a 30% US withholding tax if it were paid to customer. The intermediary party incurs no market risk because it has entered into a repurchase agreement whereby customer (the third country resident) is committed to buy the shares back at a later date for a specified price. Presumably, customer is compensated for its loss of the dividend income through the sales price or other compensation. Thus, the main purpose of the transaction is to reduce the amount of US withholding tax imposed on the dividend income. For a comment, see F. Camerlingo, *Supreme Court Decisions on Dividend Washing and Abuse of Rights in Tax Matters*, 8(4) Derivatives & Fin. Instruments 209–212 (Aug. 2006); A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64(8/9) Bull. Int'l Tax'n 446 (2010); C. Innamorato, *An Unwritten Anti-Abuse Principle in the Italian Tax System*, 48(8) Eur. Tax'n 449–453 (Aug. 2008); R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49(11) Eur. Tax'n 511 (2009), footnote no. 3.

<sup>76</sup> Art. 30 of the tax treaty between Israel and Italy (1995). Anti-abuse provisions included in certain of Italy's other bilateral treaties appear to be narrower than this. See Art. 28 of the tax treaty between Estonia and Italy (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.' Art. 30 of the tax treaty between Italy and (1997); Art. 30 of the tax treaty between Italy and Lithuania (1996); Art. 29 of the tax treaty between Italy and Kazakhstan (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.'

However, in his 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 found in the Italy–Israel 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

We gravitated toward the ‘main purpose’ standard of our proposed rule because it corresponds to the US ‘a principal purpose’ standard which is applied in a number of our statutory provisions and regulations.<sup>77</sup>

Thus, a compromise was 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.<sup>78</sup>

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<sup>77</sup> From a search run into Westlaw, it results that the language ‘principal purpose’ is included in almost 30 provisions of the Internal Revenue Code: s. 269. Acquisitions made to evade or avoid income tax (... and the principal purpose for which such acquisition was made is evasion or avoidance ...); s. 877. Expatriation to avoid tax (... such loss of citizenship did not have for one of its principal purposes the avoidance of taxes ...); s. 7872. Treatment of loans with below-market interest rates (... Any below-market loan 1 of the principal purposes of the interest arrangements of which is the avoidance of ...); s. 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 ...); s. 614. Definition of property (... the Secretary shall, on showing by the taxpayer that a principal purpose is not the avoidance of tax ...); s. 9722. Sham transactions (If a principal purpose of any transaction is to evade or avoid liability under this chapter ...); s. 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 ...); s. 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 ...); s. 453. Installment method (... neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax ...); s. 1298. Special rules (... a principal purpose of leasing the property was to avoid the provisions of this part ...); s. 1272. Current inclusion in income of original issue discount (... Clause (i) shall not apply if the loan has as 1 of its principal purposes the avoidance of any Federal tax ...); s. 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 ...); s. 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 ...); s. 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 ...); s. 306. Dispositions of certain stock (... in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax ...); s. 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 ...); s. 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.); s. 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 ...); s. 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 ...); s. 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 ...); s. 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 ...); s. 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 ...); s. 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 subsection or s. 954(i) ...); s. 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 section or to avoid the provisions of subparagraph (A)...); s. 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 ...); s. 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 ...); s. 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 ...); s. 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 ...); s. 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...).

<sup>78</sup> The main purpose test apparently was modelled after similar provisions found in treaties of other countries, such as many of the modern treaties of the United Kingdom. From a search run into the IBFD database, it results that United Kingdom had included such standard in almost 30 of its tax treaties entered into force between 1 Jan. 1930 and 31 Dec. 1999. The predecessor of the main purpose standard firstly appeared in Art. 12(5) of the tax treaty between Ireland and the United Kingdom (1976): ‘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;’ followed by the tax treaty between Guyana and the United Kingdom (1992). 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.’ Art. 13(7) (Royalties) and Art. 14(7) (Technical fees). Starting from 1993, it was then included in the tax treaty between Ghana and the United Kingdom (1993): Arts 11(9), 12(7) and 17(8) (Management and technical fees); the tax treaty between India and the United Kingdom (1993): Arts 12(11) and 13(9); the tax treaty between Ukraine and the United Kingdom (1993): Arts 11(7) and 12(5); the tax treaty between Indonesia and the United Kingdom (1993): Arts 11(9) and 12(7); the tax treaty between Uzbekistan and the United Kingdom (1993): Arts 11(9), 12(7), 21(3) (Other Income) and 23(2) (Limitation of relief); the tax treaty between Russia and the United Kingdom (1994): Arts 11(6) and 12(5); the tax treaty between Azerbaijan and the United Kingdom (1994): Arts 11(8), 12(7), 21(3) and 23(2); the tax treaty between Kazakhstan and United Kingdom (1994): Arts 11(9), 12(8), 21(3) and 23(2); the tax treaty between Vietnam and the United Kingdom (1994): Arts 11(7) and 12(7); the tax treaty between Malta and the United Kingdom (1994): Arts 11(7), 12(7) and 21(3); the tax treaty between Estonia and the United Kingdom (1994): Arts 11(9), 12(7), 22(3) and 24(2); the tax treaty between Mexico and the United Kingdom (1994): Arts 11(11), 12(7) and 21(5); the tax treaty between Bolivia and the United Kingdom (1994): Arts 11(8) and 12(7); the tax treaty between Argentina and the United Kingdom (1996): Arts 11(9), 12(7) and 21(4). The tax treaty between Venezuela and the United Kingdom (1996) was the first one 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.’ Arts 11(9), 12(7) and 21(5); the tax treaty between Mongolia and the United Kingdom (1996): Arts 10(6), 11(10), 12(7), 22(4) and 25(2); the tax treaty between Latvia and the United Kingdom (1996):

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.<sup>79</sup>

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, public company tests, as well as active business tests). In this regard, the US Senate Committee on Foreign Relations 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.<sup>80</sup>

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 *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 section 877(a)(2) among the IRC provisions using 'a/one of the principal purposes' anti-abuse language. Firstly, *Santa Fe* was not a tax case and did not interpret any provisions of the IRC. Secondly, its conclusions are totally opposing those of several judicial decisions involving

sections 367 and 877. *Santa Fe* might have caused enough confusion to lead Senate rejecting 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 multiemployer 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 parent had sold its subsidiary, parent would have not been liable for withdrawal liability unless 'a principal purpose' of the transaction was to 'evade or avoid' parental liability.<sup>81</sup> 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

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Art. 11(8), 12(7), 22(4) and 24(2); the tax treaty between Korea (Rep.) and the United Kingdom (1996): Arts 10(6), 11(10), 12(7) and 22(4); the tax treaty between Malaysia and the United Kingdom (1996): Arts 10(6), 11(7) and 12(7); the tax treaty between Lesotho and the United Kingdom (1997): Arts 10(6), 11(9), 12(7), 13(8) and 22(4); the tax treaty between Singapore and the United Kingdom (1997): Arts 10(7), 11(9) and 12(8); the tax treaty between Falkland Islands and the United Kingdom (1997): Arts 10(6), 11(5), 12(5) and 22(4); and the tax treaty between Oman and the United Kingdom (1998): Arts 10(6), 11(5), 12(5), 21(4) and 23. However, it should be noted that Art. 2(2) of the Protocol to tax treaty between Italy and the United States (1984) already included 'a principal purpose' standard: 'Para. 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.' Technical Explanation to Art. 2 of the 1984 Protocol 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. E.g. this test would be met if an Italian company owned by third country residents conducts business operations in Italy and its US 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.'

<sup>79</sup> JCX-76-99, Testimony of the Staff of the Joint Committee On Taxation Before The Senate Committee on Foreign Relations Hearing On Tax Treaties And Protocols With Eight Countries (25 Oct. 1999), at 4.

<sup>80</sup> L. A. Sheppard & A. A. Rossi, *Where Is the Italian Tax Treaty?* 39 Tax Notes Int'l at 791 et seq. (29 Aug. 2005); see also DIPLOMATIC NOTE, US-Italy Diplomatic Note (2007): 'Ratification of the Convention by the Government of the United States of America is subject to the deletion of the final paragraph of Art. 10 (Dividends), the final paragraph of Art. 11 (Interest), the final paragraph of Art. 12 (Royalties), the final paragraph of Art. 22 (Other Income) of the Convention and para. 19 of Art. 1 of the Protocol, with the renumbering of para. 20 of Art. 1 of the Protocol as para. 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, *Financial Products Anti-abuse Provisions in New Income Tax Treaties Rejected by Senate*, 2(2) Derivatives & Fin. Instruments 123-128 (1 Apr. 2000).

<sup>81</sup> US: *Santa Fe Pacific Corp. v. Central States, Southeast and Southwest Areas Pension Fund*, United States Court of Appeals, Seventh Circuit, 22 Apr. 1994, 22 F.3d 725, 73 A.F.T.R.2d 94-1820, 62 USLW 2703, at 726-727.

preventing one employer from unloading his pension obligations onto the other employers in a multi-employer plan.<sup>82</sup>

However, such interpretation of the term 'a principal purpose' contrasts starkly with settled case-law involving IRC provisions, such as sections 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 section 877 as one of the many Code provisions which contains such language. A 1984 Tax Court case, regarding whether 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, section 511(g)), section 877 generally provided that a nonresident alien individual who lost his United States citizenship should be subject to tax on his United States source income, for the ten-year period following such loss, at the graduated tax rates applicable to United States citizens rather than more favourable rates applicable to nonresident aliens, unless the loss did not have for *one of its principal purposes* the avoidance of United States taxes. Section 877(e) specifically assigned the burden of proving the lack of a tax avoidance motive on the expatriate if respondent established that it was reasonable to believe that the individual's loss of United States citizenship would result in a substantial reduction in taxes. In *Furstenberg v. Commissioner*, taxpayer was able to carry her burden under section 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, 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 petitioner how important 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. Petitioner had no further discussions with her accountant in 1975. Her income in 1975 and 1976 came from two trust distributions to her and from the sale of securities. The distribution from Trust No. 1, a complex *inter vivos* trust established by petitioner's 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 amount 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 petitioner did not have tax avoidance as *one of her principal purposes* in expatriating. Interestingly, the 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 'in pursuance of a plan having as one of its principal purposes the avoidance of Federal income'<sup>83</sup>

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

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 US 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.

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

Prior to the Deficit Reduction Act of 1984, section 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

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<sup>82</sup> US: *Santa Fe Pacific Corp. v. Central States, Southeast and Southwest Areas Pension Fund*, *supra* n. 81, at 727–728.

<sup>83</sup> US: *Furstenberg v. Commissioner of Internal Revenue*, United States Tax Court, 26 Nov. 1984, 83 T.C. No. 43, 83 T.C. 755, Tax Ct. Rep. (CCH) 41, 633, at 775–776.

1042(d) of the Tax Reform Act of 1976 afforded taxpayers a remedy through a declaratory judgment procedure in 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.*, 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 Bros.* entered into a 50–50 joint venture with a United Kingdom 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 nonexclusive licenses of its secret process to foreign companies, but since only nominal royalties were produced, both licenses were cancelled. *Dittler Bros.* 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 Bros.* 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. (OLINV), was wholly owned by SSNV. *Dittler Bros.* and NWBV each contributed USD 25,000 to SSNV as partial consideration for their respective 50% stock interest. In addition, *Dittler Bros.* 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 OLINV 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 OLINV 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 OLINV. Accordingly, the fight with IRS concerned whether the retention of 25% of OLINV's after tax earnings was pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes.

Tax Court determined that *Dittler Bros.* was denied a favourable ruling on two grounds. Firstly, IRS concluded that neither SSNV nor OLINV would devote the property received (manufacturing know-how) to the active conduct of a trade or business, within the meaning of section 3.02 (1) of Rev. Proc. 68-23, 1968-1 C.B. 821. Secondly, 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 intentment 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 US 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.*<sup>84</sup>

In conclusion, what is the correct meaning of the term principal 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 has been 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

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<sup>84</sup> US: *Dittler Brothers, Inc. v. Commissioner of Internal Revenue*, United States Tax Court, 27 Aug. 1979, 72 T.C. 896, at 914–915.

like to apply the former, which is more lenient, because allows them to preserve treaty benefits by asserting a relatively weak business purpose, while, on the other hand, tax authorities would prefer the latter, which is stricter, because permits them to deny treaty benefits if tax avoidance is just more than a trivial or de minimis purpose.

Analysis of the legislative history<sup>85</sup> and regulations of section 129 of the 1939 Internal Revenue Code,<sup>86</sup> predecessor to section 269,<sup>87</sup> as well as extensive case law before<sup>88</sup> and after<sup>89</sup> *Dittler* clearly suggests that any standard using principal purpose is met only when the purpose to evade tax exceeds in importance any other purpose.<sup>90</sup>

Therefore, if US 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 would not inappropriately invoke the main purpose provisions to challenge legitimate business transactions, why citing the ambiguous *Santa Fe*'s ruling? In the authors' opinion, US 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 wrong interpretation of term given in *Santa Fe* could be considered, a posteriori, a strategic mistake. In 1999, the US did not oddly take advantage of the opportunity to play a leadership role in shaping the future direction of this

important principle. The fact that the PPT rule is currently included in more than 1.100 matched agreements demonstrates how important was to the US in 1999 to adopt such standard in the tax treaties with Italy and Slovenia. However, as mentioned, the inclusion of such standard should have been explicitly based on the *Dittler* ruling, the only able to ensure a consistent and reasonable application of this standard. In 1999, the US just lost the chance to unilaterally impose its own interpretation of PPT rule. Today, with the US refusing to sign on to the MLI, the concerns of Ms. Paull and of Sen. Hagel as to whether other countries tax authorities would appropriately administer such provision are more important than ever.

## 6 ANTI-HYBRID PROVISIONS

TRA17 contains two anti-hybrid provisions that directly implement the single tax principle, similarly to the ATAD. The first, section 14101 of the Senate amendment, new section 245A(e), disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. The second, section 14223 of the Senate amendment, section 267A, limits the deductibility of payments on hybrid instruments or to hybrid entities. These provisions clearly implement OECD BEPS Action 2 in accordance with the single tax principle.

In particular, on the one hand, section 245A(e)(1) provides that the dividend received deduction is not available for any dividend received by a US shareholder from a controlled foreign corporation 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% owned foreign corporation received a deduction (or other tax benefit) from taxes imposed by a foreign country.'<sup>91</sup> In addition, if a CFC receives a hybrid dividend

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<sup>85</sup> Senate Report No. 627, 78th Cong. 1st Sess. (22 Dec. 1943), appearing at 1017, 1944 Cum. Bul.: 'The House bill made section 129 operative if one of the principal purposes was tax avoidance. Your committee believes that the section should be operative only if the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose.' For a comment see H. J. Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58(2) Harv. L. Rev. 196-225 (Dec. 1944); D. B. Chase, *Analysis of Section 129 of the Internal Revenue Code*, 30 Cornell L. Rev. 421 (1945), <http://scholarship.law.cornell.edu/clr/vol30/iss4/3> (accessed 5 Apr. 2018).

<sup>86</sup> Regulations 118, s. 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.'

<sup>87</sup> R. S. Rice, *Internal Revenue Code Section 269: Does the Left Hand Know What the Right is Doing*, 103 U. Pa. L. Rev. 579 (1955); P. E. Peterson, *The 'principal purpose' test under Section 269: how it's being applied in the courts*, 20 J. Tax'n 16 (1964); D. E. Watts, *Acquisitions Made to Avoid Taxes: Section 269*, 34 Tax L. Rev. 539 (1979).

<sup>88</sup> US: *Commodores Point Terminal Corp. v. C.I.R.*, United States Tax Court, 27 Sept. 1948, 11 T.C. 411; *Hawaiian Trust Co. Limited v. US*, United States Court of Appeals Ninth Circuit, 25 May 1961, 291 F.2d 761, 7 A.F.T.R.2d 1553, 61-1 USTC P 9481; *House Beautiful Homes, Inc. v. C.I.R.*, United States Court of Appeals Tenth Circuit, 19 Dec. 1968, 405 F. 2d 61; *Bobsee Corp. v. United States*, 411 F. 2d 231, 239 (5th Cir. 1969); *Canaveral International Corp. v. Commissioner of Internal Revenue*, United States Tax Court, 29 Jan. 1974 61 T.C. 520; *D'Arcy-Macmanus & Masius, Inc. v. Commissioner of Internal Revenue*, United States Tax Court, 2 Jan. 1975, 63 T.C. 440.

<sup>89</sup> US: *Hershey Foods Corp. v. Commissioner of Internal Revenue*, United States Tax Court, 18 Feb. 1981, 76 T.C. 312; *Pitcher v. Commissioner*, 84 T.C. 85 (1985); *Finoli v. Commissioner*, 86 T.C. 697, 722 (1986); *Cottle v. Commissioner*, 89 T.C. 467, 486 (1987); *Teller v. C.I.R.*, United States Tax Court 15 July 1992 T.C. Memo. 1992-402 1992 WL 163668 64 T.C.M. CCH 166.

<sup>90</sup> B. M. Willis, *A Principal Purpose: There Can Be Only One*, Tax Analysts (10 June 2013), <http://www.taxhistory.org/www/features.nsf/Articles/178104B57F0667F985257B8600468B3E?OpenDocument> (accessed 5 Apr. 2018); J. R. Macdonald, *'Time Present and Time Past': US Anti-Treaty Shopping History, Policy and Rules*, 70 Tax Law. 5 (2016).

<sup>91</sup> S. 245A(e)(4) of TRA17.



from another CFC, the hybrid dividend is treated as subpart F income.<sup>92</sup> Finally, section 245A(e)(3) provides, by reference to section 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, section 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: (1) 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 purposes or is subject to tax,<sup>93</sup> or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.<sup>94</sup> 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.’<sup>95</sup> Finally, a hybrid entity is any entity which is either: (1) 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,<sup>96</sup> or (2) 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.<sup>97</sup>

It may seem strange that the US took this action while making the CFC to CFC look through rule section 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 US will tax at residence if there is no tax at source (section 245A(e)) and will tax at source if there is no tax at residence (section 267

(a)). But what about the case where both source and residence are foreign? The US 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 US?

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 US multinational planning that many countries blame on the US 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.<sup>98</sup>

Thus, neither section 245A(e) nor section 267A(a) will significantly impact foreign reverse hybrid entities, i.e. entities that are treated as opaque by its foreign investor and transparent under the jurisdiction where they are established, such as a Dutch CV-BV or a Luxembourg SCS-Sarl structure. That might have adverse consequences for both 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.<sup>99</sup> A US

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<sup>92</sup> S. 245A(e)(2) of TRA17. See Conference Report to TRA17, *supra* n. 36, at 598: ‘If a controlled foreign corporation with respect to which a domestic corporation is a US shareholder receives a hybrid dividend from any other controlled foreign corporation with respect to which the domestic corporation is also a US 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 US 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).’

<sup>93</sup> S. 267A(b)(1)(A) of TRA17.

<sup>94</sup> S. 267A(b)(1)(B) of TRA17.

<sup>95</sup> S. 267A(c) of TRA17. See Conference Report to TRA17, *supra* n. 36, at 663.

<sup>96</sup> S. 267A(d)(1) of TRA17.

<sup>97</sup> S. 267A(d)(2) of TRA17.

<sup>98</sup> Baker McKenzie, *supra* n. 41, at 31–32.

<sup>99</sup> This description is derived from a Jones Day’s presentation held at the International Tax Seminar organized by the Detroit Chapter of Tax Executives Institute (27 Apr. 2016), <http://teidetroitchapter.camp7.org/resources/Documents/Jones%20Day%20-%20TEI%20Detroit%20-%20International%20Tax%20Seminar%202016v2.pdf> (accessed 5 Apr. 2018), at 249–250; see also J. Vleggeert, *Dutch CV-BV Structures: Starbucks-Style Tax Planning and State Aid Rules*, 70(3) Bull. Int’l Tax’n 173–174 (2016): ‘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

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 US parent company and further develops such IP under a contract R&D (CRA) or cost sharing (CSA) arrangement with US parent. CV/SCS grants an IP license to a Dutch (BV) or Luxembourg (Sarl) principal. BV/Sarl may either (1) sell products throughout Europe and retains local in-country service companies for support services, or (2) grants sublicenses to European operating companies. The tax consequences are the following: (1) service or operating companies across Europe remit local country tax on routine income; (2) BV remits 25% tax on net sales or licensing income reduced by royalty payments to CV; (3) no Dutch withholding on royalties under domestic law; (3) CV is treated as a pass-through for Dutch purposes and thus is not subject to Dutch tax; and (4) US parent achieves deferral of US tax on its non-US profits as a result of CV/SCS's hybrid treatment. On the hand, the US treats the CV/SCS as a corporation and, as a consequence, income earned by the CV/SCS generally will not be subject to current US tax. Moreover, even if the CV/SCS is treated as a CFC, interest and royalty income earned from BV, which otherwise would qualify as subpart F income, may nonetheless not be subject to current US taxation as a result of either section 954(c)(3) or section 954(c)(6). On the other hand, payments to the CV/SCS, generally are also 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 CV/SCS's income as derived by its owners, including its US owners.

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 would 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

That 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. 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.

That 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. Netherlands tried unsuccessfully to postpone the effective date to 1 January 2024, 'to give third countries, like the US, sufficient time to amend their legislation to the neutralize the effects of a hybrid mismatch in the country of the payment recipient.'<sup>100</sup> Indeed, according to OECD BEPS Action 2 Report, (Recommendation 5), mismatch

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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.'

<sup>100</sup> See unofficial translation of the assessment by the Dutch government of the proposal of the European Commission regarding hybrid mismatches with third countries (26 Oct. 2016), [https://www.nob.net/sites/default/files/content/article/uploads/english\\_translation\\_of\\_the\\_assessment\\_by\\_the\\_dutch\\_government\\_of\\_the\\_proposal\\_regarding\\_hybrid\\_mismatches\\_relating\\_to\\_third\\_countries.pdf](https://www.nob.net/sites/default/files/content/article/uploads/english_translation_of_the_assessment_by_the_dutch_government_of_the_proposal_regarding_hybrid_mismatches_relating_to_third_countries.pdf) (accessed 5 Apr. 2018), at 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 amend national legislation in order to execute its tax claim or to take the necessary measures before the EU Member State taxes the profit (or at least refuse the deduction).* The implementation date of 1 Jan. 2019 proposed in the present directive, will likely not give these third countries enough time. Furthermore, third countries will file notices of objection against an EU Member State taxing the profit, if these third countries believe that this profit is their due and if they consider that the EU Member State is wrongly taxing this profit by virtue of the directive. This is also an argument for giving third countries the chance to tax these profits themselves.'

arrangements can also be addressed through changes to domestic law. The residence state of the foreign investor, in this case, the US, could improve its CFC regime in order to ensure that income earned by the CV/SCS will be currently subject to US tax. As it will be described below, this could be done by closing the two biggest loopholes of Subpart F regime, namely the same-country exception of section 954(c)(3) and the look-through exception of section 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 additional US tax burden.

Regardless of the actions that have been undertaken by the US, as a result of Article 9a(1), since parent company is located in a jurisdiction, the US, 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.

The first question that should be asked is whether rules addressing hybrid mismatches are actually necessary. In the authors' opinion, 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 Netherlands does not have to allow for an exemption from or a reduction of Dutch tax. Article 24(4) 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, CV is viewed as a pass-through 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 CV generally would not be subject to tax currently in either the United States or the Netherlands. Consequently, Article 24(4) provides that the withholding rate should not be reduced.<sup>101</sup>

That view had also initially been confirmed by JG Wijn, State Secretary for Finance in a letter to the President of the Senate of the States General dated 3 May 2005, where he argued that Netherlands was no longer obliged to reduce withholding rate on dividends and interest paid by the BV to the CV.<sup>102</sup> 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 nontaxation. However, in the same letter, he also mentioned 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 purposes of determining whether real activities are carried out: (1) the dividend distributing company is (for tax purposes only) established in the Netherlands; (2) whether directors and/or employees are active in the Netherlands; (3) whether these directors have sufficient professional knowledge; (4) where important decisions are taken; (5) where the company's primary bank account is kept; (6) where the bookkeeping takes place; (7) the amount of equity and debts; (8) which activities are carried out in or through the Netherlands; (9) whether the employees active in the Netherlands are sufficiently qualified; (10) where real risks are run; and (11) whether the remunerations for the activities carried out and the risks are at arm's length.<sup>103</sup> Granting treaty benefits to entities that do not qualify based on the literal interpretation of Article 24(4) is the reason why the 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 just fine 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,<sup>104</sup>

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<sup>101</sup> K. Martin, *Holland*, Norton Rose Fulbright (1 Aug. 2005), <http://www.nortonrosefulbright.com/knowledge/publications/154270/holland> (accessed 5 Apr. 2018): 'Dividends paid by a Dutch company to someone without the benefit of treaty protection attract a 25% withholding tax. The new protocol to the US Treaty has a clause that bars treaty benefits in cases where "hybrid" entities are used, like in this case. Even though the Dutch view a dividend paid by the BV as received in the US directly, the protocol rules out treaty benefits. The protocol language is intended to prevent governments from being whipsawed by clever tax planning.'

<sup>102</sup> NL: Kamerstukken 2004/05, 29 632, B Herdruk, <https://zoek.officielebekendmakingen.nl/dossier/29632/ksr-20042005-29632-B-h1?resultIndex=1&sorttype=1&sortorder=4> (accessed 5 Apr. 2018). For an English translation, see J. Vleggeert, *supra* n. 99, at 177.

<sup>103</sup> IBFD News, *Netherlands Decree on application of Netherlands-US tax treaty re hybrid entities published* (12 July 2005); see also P. J. Connors & R. V. Femia, *Application of US Treaties to Hybrid Entities*, 35(3) Tax Mgmt. Int'l J. 154 (10 Mar. 2006), [https://www.millerchevalier.com/sites/default/files/news\\_updates/attached\\_files/femia202006-03-1020bna20tax20management.pdf](https://www.millerchevalier.com/sites/default/files/news_updates/attached_files/femia202006-03-1020bna20tax20management.pdf) (accessed 5 Apr. 2018).

<sup>104</sup> Art. IV(7)(a) of the tax treaty between Canada and the United States (1980) (as amended through 2007).

Denmark,<sup>105</sup> France,<sup>106</sup> Iceland,<sup>107</sup> Ireland,<sup>108</sup> Italy,<sup>109</sup> South Africa,<sup>110</sup> Thailand<sup>111</sup> and Venezuela.<sup>112</sup> In particular, examples in Technical Explanation address the issue of reverse hybrid entities. The language contained in Technical Explanation to Article IV(7)(a) of the Canada – United States Income and Capital Tax Treaty 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 US 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 US tax purposes, CanLP, and not USCo, is viewed as deriving the dividend. Because the treatment of the dividend under US tax law in this case is not the same as the treatment under US law if USCo derived the dividend directly, subparagraph 7(a) provides that USCo will not be considered as having derived the dividend<sup>113</sup>

Therefore, Canada is 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 US, 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 US has solved the issue of stateless income made possible by the CV/BV structure. According to their opinion, due to GILTI, the US no longer permits that profits from intellectual property, such as royalty fees, are transferred out of a Netherlands-based entity without being taxed anywhere.<sup>114</sup> 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 taxable income of the reverse hybrid.

In conclusion, it should be noted that all those problems, especially avoiding that other countries might tax what the US believes is its income, would have been solved if TRA17 had adopted a similar provision to that of Obama administration,<sup>115</sup> according to which section 954(c)(3) and section 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, CV's IP income would have been currently subject to US tax. However, such proposal would have modified some of the core provisions of Subpart F regime denying the possibility for US MNEs to engage in foreign-to-foreign profit shifting. When Congress, on behalf of US multinationals, forced Treasury to withdraw Notice 98-11, 1998-1 C.B. used two arguments to justify foreign-to-foreign profit shifting. Firstly, it was said that reduction of foreign taxes through hybrid entities is a good thing for US Treasury because if US MNEs pay less tax to foreign administrations, that means they will pay more tax to the US when

## Notes

<sup>105</sup> Art. 4(1)(d) of the tax treaty between Denmark and the United States (1999) (as amended through 2006).

<sup>106</sup> Art. 4(3) of the tax treaty between France and the United States (1994) (as amended through 2009). See also Joint Committee on Taxation, *Explanation of the Proposed Protocol to the Income Tax Treaty Between the United States and France* (6 Nov. 2009), [https://online.ibfd.org/data/treaty/docs/pdf/tr\\_fr-us\\_02\\_eng\\_1994\\_rt\\_ad13.pdf](https://online.ibfd.org/data/treaty/docs/pdf/tr_fr-us_02_eng_1994_rt_ad13.pdf) (accessed 5 Apr. 2018) at 34: 'The Technical Explanation also illustrates the application of the fiscally transparent entities rules in a circumstance in which a French-source item of income is paid to an entity organized in France rather than ... in the United States. In this circumstance, if US tax law treats the French entity as a corporation and the entity is owned by a US shareholder who is a US resident for US tax purposes, the income received by the entity is not considered derived by the US shareholder even if the entity is treated as fiscally transparent under French tax law. Under US law, the French corporation is treated as a separate taxable entity, and the US shareholder of that corporation generally is not subject to US tax on income received by the entity until the shareholder receives a distribution on the income.'

<sup>107</sup> Art. 1(6) of the tax treaty between Iceland and the United States (2007).

<sup>108</sup> The tax treaty between Ireland and the United States (1997) (as amended through 1999) Protocol, para. 1.

<sup>109</sup> Art. 4(1)(b) of the tax treaty between Italy and the United States (1999).

<sup>110</sup> Art. 4(1)(d) of the tax treaty between South Africa and the United States (1997).

<sup>111</sup> The tax treaty between Thailand – and the United States – Technical Explanation to the 1996 Treaty (1997).

<sup>112</sup> Art. 4(2) of the tax treaty between United States and the Venezuela (1999).

<sup>113</sup> The tax treaty between Canada and the United States – Technical Explanation to the 2007 Protocol (2007). Similar language is contained in of the tax treaty between Denmark and the United States – 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 US tax purposes as a corporation and is owned by a US shareholder who is a US resident for US 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.'

<sup>114</sup> I. Gottlieb, *Dutch Hybrid Rules May Not Be Needed After US Tax Reform*, Tax Management Transfer Pricing Report (BNA) (22 Feb. 2018).

<sup>115</sup> See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals* (Feb. 2016), at 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), at 58–66.

earnings are eventually repatriated. Secondly, 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. Therefore, it is clear why TRA17 did not include Obama's administration proposal. In the authors' opinion, the US finds itself confronted by a difficult choice: (1) either currently tax MNEs' offshore income by eliminating deferral or (2) doing nothing and risking that other countries, such as EU Member States through ATAD II, might tax what the US believes is its tax base. Basically, it is like a zero-sum game where if US tax authorities gain, US multinationals lose and vice-versa.

## 7 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 US stood aside, it was not clear that the EU could implement BEPS on its own, and China is just beginning to adopt BEPS measures.<sup>116</sup> But TRA17 represents the incorporation of BEPS into US domestic tax law. TRA17 should also 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.

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### Notes

<sup>116</sup> R. S. Avi-Yonah & Haiyan Xu, *China and the Future of the International Tax Regime* (21 Oct. 2017). U of Michigan Law & Econ Research Paper No. 17-017; U of Michigan Public Law Research Paper No. 572. SSRN: <https://ssrn.com/abstract=3056796> (accessed 5 Apr. 2018).