A Positive Dialectic: BEPS and The United States

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SYMPOSIUM ON RUTH MASON, "THE TRANSFORMATION OF INTERNATIONAL TAX"

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This essay addresses the interaction between the changes in the international tax regime identified by Mason and U.S. international tax policy. Specifically, I will argue that contrary to the general view, the United States actively implemented the Organisation for Economic Co-Operation and Development (OECD)/G20 Base Erosion and Profit Shifting (BEPS) recommendations through the Tax Cuts and Jobs Act of 2017 (TCJA). Moreover, the changes of the TCJA influenced the current OECD effort of BEPS 2.0. Thus, the current state of affairs can be characterized as a constructive dialogue: The OECD moves (BEPS 1), the United States responds (TCJA), the OECD moves again (BEPS 2). If the international tax regime is to survive, it is important that BEPS 2 will succeed, and that the US will then go along and amend the TCJA accordingly. From this kind of positive dialectic, a new international tax regime fit for the twenty-first century may emerge.

Why International Taxation is Important

Most countries in the world rely primarily on three types of taxes: personal income taxes on individuals, corporate income taxes on corporations, and value added taxes on consumption (VAT). These three types of taxes serve three different goals of taxation. VAT is primarily about raising revenue for governmental expenditures on public goods like defense or infrastructure, as well as the welfare state. In most countries other than the United States, VAT is the largest source of government revenue, as well as the most reliable. Personal income tax is about redistributing income from the rich to the poor in order to achieve a more equal society, which is justified because the pre-tax distribution of income is to a large extent dependent on luck (e.g., where you are born and who your parents are). Corporate income tax is about regulating major actors in the economy, and in particular multinational enterprises.

VAT is governed by the destination principle, under which each country taxes consumption within its territory (i.e., it exempts exports and is imposed on imports). Personal income tax and corporate income tax, on the other hand, are generally governed by where the taxpayer resides and are imposed on a worldwide basis. Personal income tax must be imposed globally because its redistributive goal can only be achieved by taxing the rich on all of their income "from whatever source derived" (U.S. Constitution, Amendment XVI). Corporate income tax must be imposed globally because otherwise multinational enterprises would shift their income abroad and thereby escape the regulatory purpose of corporate income tax.

The international tax regime represents the attempt over the last century to achieve these goals by applying personal income tax and corporate income tax to global income. It is based on two principles that together govern the allocation of income among taxing jurisdictions. The Benefits Principle, developed a century ago, states that

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active (business) income should be taxed primarily at source, while passive (investment) income should be taxed primarily at residence. The Single Tax Principle, developed primarily in the past decade (although its roots go back over a century) states that income should be subject to tax once (i.e., it rejects both double taxation and double non-taxation) at the residence rate for passive income and at the average source rate for active income. These principles are embodied in the over three thousand bilateral income tax treaties and form the foundation for BEPS 1, BEPS 2, and the TCJA. They are necessary because neither personal income tax nor corporate income tax can achieve their goals without taxing cross-border income, and some rule is needed to allocate income among taxing jurisdictions.

The United States and BEPS 1

From 2013 to 2015, the United States participated in BEPS 1. However, the general view in the United States is that following the conclusion of the BEPS negotiations and the change of administration in 2017, the United States stepped back from the BEPS process. While the European Union was charging ahead with implementing BEPS through the Anti-Tax Avoidance Directive, the United States stated that it was already in compliance with all BEPS minimum standards and therefore other than country-by-country reporting it had no further BEPS obligations. The United States refused to join the multilateral instrument to implement BEPS into tax treaties, and did not join the common reporting standards to further automatic exchange of information, leading the European Union to call it a tax haven. The United States did adopt BEPS provisions in its model tax treaty, but those have not been implemented in any actual U.S. treaty. Thus, most observers believe that the United States has abandoned the BEPS effort.

But this view is wrong. The TCJA clearly relies on BEPS principles and in particular on the Single Tax Principle. This represents a triumph for the G20/OECD and is incongruent with the generally held view that the United States will never adopt BEPS. The U.S. reliance on BEPS principles can be seen in both the outbound and inbound provisions of the TCJA.

For outbound transactions, the new Global Intangible Low-Taxed Income (GILTI) provision of TCJA means that Amazon, Apple, Facebook, Google, Netflix, and other technology companies will have to pay tax at 10.5 percent on future income of this type because they have controlled foreign corporations that produce "tested income" (and no loss) in excess of 10 percent over their basis in offshore tangible assets, which is zero, or close to it, since they derive almost all of their income from intangibles. This imposes residence taxation in cases where there is no or low taxation at source, consistently with the Single Tax Principle. For inbound transactions, the new Base Erosion Anti-Abuse Tax (BEAT) means that a minimum tax of 10 percent will apply to many payments to foreign related parties. This imposes source taxation where there may not be taxation at residence, again consistently with the Single Tax Principle.

The TCJA also contains two anti-hybrid provisions that directly implement the Single Tax Principle, similarly to the European Anti-Tax Avoidance Directive. The first, Internal Revenue Code (Code) Section 245A(e), disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. This means that if there is a deduction in the source country the income will be taxed by the United States as the residence country. The second, Code Section 267A, limits the deductibility of payments on hybrid instruments or to hybrid entities, meaning that there will be no deduction in the United States as the source country if there is no income in the residence country. These provisions clearly implement BEPS Action 2 in accordance with the Single Tax Principle.

Overall, the TCJA contains multiple provisions that incorporate the principles of BEPS into domestic U.S. tax law. Together with the changes in the 2016 model U.S. tax treaty, these provisions mean that the United States is following the European Union and China in implementing BEPS, and in particular its underlying principle, the Single Tax Principle.

The TCJA was originally driven by the desire of U.S. multinational entities to adopt a participation exemption for dividends from controlled foreign corporations and enable the entities to repatriate their "trapped income", which by 2017 amounted to about US$3 trillion. This was explicitly based on the fact that most other OECD countries had such an exemption, and in particular that Japan and the United Kingdom had recently switched to an exemption from worldwide taxation. Thus, in this case the United States was explicitly the follower and not the leader.

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

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

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

Second, in conjunction with adopting the participation exemption, TCJA significantly strengthened Subpart F. Specifically, Code section 951A now currently taxes U.S. parents of controlled foreign corporations on their GILTI, at a 10.5 percent rate. That income is defined broadly as any income that exceeds a 10 percent return on the controlled foreign corporation's basis in its tangible assets (the "hurdle rate"), with a credit for foreign taxes. Thus, the U.S. parents of controlled foreign corporations are effectively subject to a minimum tax of 10.5 percent on their offshore earnings that exceeds the hurdle rate. The tax on GILTI is consistent with the Single Tax Principle because, contrary to pre-TCJA law, it ensures that offshore earnings that exceed the hurdle rate are taxed at 10.5 percent, and that a residence-based tax applies to those earnings to the extent they are not taxed at source.

Third, there is a new BEAT imposed at 10 percent on deductible payments made by U.S. corporations to their foreign affiliates (which can be foreign parents or controlled foreign corporations). This tax upholds the Single Tax Principle because it imposes tax at source under circumstances where there may not be a tax at residence.

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

The United States and BEPS 2

BEPS 2 is the continuation of BEPS 1 from 2018 onward. It attempts to address some of the unfinished business of BEPS 1, especially in regard to the digital economy. It also represents a reaction to the TCJA, and thus continues the constructive dialogue between the United States and the EU on building an updated international tax regime. As developed by the OECD, BEPS 2 has two pillars. Pillar One is the extension of BEPS 1 action 1, dealing with the digital economy. Pillar 2, on the other hand, is a direct extension of the TCJA.

Pillar One: Evolution or Revolution?

Pillar One is still in process but what has been revealed so far envisages far-reaching changes to the international tax regime, primarily by partially abandoning the arm's length principle (incorporated in Article 9 of the tax treaties) and the permanent establishment threshold (incorporated in Article 7 of the tax treaties). Neither of these changes are driven by the United States, and it remains to be seen whether they will succeed in averting the widespread adoption of digital services taxes intended to impose some tax burden on U.S. multinationals.

Pillar One covers "highly digital business models" but also other consumer-facing businesses.[1] For businesses that fall within its scope, Pillar One replaces the Permanent Establishment rule, which depended on physical presence, with a "new nexus" based on sales into a taxing jurisdiction, with a country specific sales threshold "calibrated to ensure that jurisdictions with smaller economies can also benefit." Pillar One also creates a new profit allocation rule to sales based on a formula that goes beyond the current arm's length principle, and a three-tier mechanism for allocating income to taxing jurisdictions.

This proposal represents a recognition that BEPS 1 failed to address the challenges posed by the digitalization of the economy (Action 1) and also failed to reform nexus and transfer pricing rules sufficiently (Actions 7-10). The result was a rising tide of unilateral actions by source jurisdictions, beginning with the United Kingdom diverted profits tax (2015) and continuing with many countries adopting digital services taxes. The OECD proposal seems to be trying to persuade countries to abandon such unilateral actions, which may undermine the international tax regime by emphasizing non-income taxes not subject to tax treaties. It remains to be seen whether this proposal will succeed.

From a U.S. perspective, Pillar One is adverse to U.S. interests as the residence country of the digital giants, which also grants a foreign tax credit. That is why Treasury Secretary Steven Mnuchin suggested that Pillar One be made elective, which is anathema to source jurisdictions. If Pillar One goes forward, the U.S. goal would be to minimize the amount allocated to source countries and to strengthen the dispute resolution provisions. The more the United States succeeds in the OECD, the less are other countries likely to give up on the digital service taxes.

In my opinion, the correct U.S. approach would be not to fight against Pillar One but to raise its own taxes on the digital giants. The profits of the digital giants represent monopoly rents and they can therefore be subject to high taxation without affecting the behavior of these entities or causing deadweight loss.[2] If the United States were to adopt its own residence-based highly progressive corporate tax, it could then grant foreign tax credits for income taxes levied under the three tranches of Pillar One without ceding too much taxing jurisdiction to source countries. Any amount allowed under Pillar One is likely to be much lower than a plausible U.S. residence-based tax. (Compare for example the US$14 billion the European Union is claiming from Ireland for taxes it did not collect

[1] Org. for Econ. Co-Operation & Dev., Secretariat Proposal for a "Unified Approach" Under Pillar One.

[2] For a defense of this view, see Reuven Avi-Yonah & Lior Frank, *Antitrust and the Corporate Tax: Why We Need Progressive Corporate Tax Rates*, 167 Tax Notes 1199 (May 18, 2020).

from Apple with the much higher amount Apple owed the United States for its Irish profits under the TCJA). Digital service taxes, on the other hand, would not be creditable and are likely to be passed on to consumers (like a VAT).

Pillar Two: Globalizing the TCJA

Unlike Pillar One, Pillar Two is a direct outgrowth of the TCJA. The OECD summarizes Pillar Two (Global Anti-Base Erosion) as having four components : (a) an income inclusion rule that taxes foreign branches or subsidiaries of multinational entities at residence if they are not subject to a minimum effective tax rate at source; (b) an undertaxed payments rule that would deny deductions at source to payments not subject to an effective minimum rate of tax at residence; (c) a switch-over rule in tax treaties that would let residence jurisdictions apply global taxation rather than exemption to income not subject to a minimum tax at source; and (d) a subject to tax rule in tax treaties that would subject payments to withholding taxes at source if the payment is not subject to minimum tax at residence.[3]

The income inclusion rule is based on the same minimum tax concept as GILTI, while the undertaxed payments rule is similar to the BEAT. Conceptually, all of these rules implement the Single Tax Principle.

The Global Anti-Base Erosion rules represent improvements over the TCJA. The income inclusion rule is an improvement over GILTI because (a) it does not deny foreign tax credits, and (b) it may be applied on a country by country basis, preventing cross-crediting. The undertaxed payments rule is an improvement over BEAT because BEAT does not take into account the tax rate in the payee jurisdiction.

The details of Pillar Two remain to be hashed out. I would suggest, however, that a key element is the future behavior of the United States. A future administration may raise the corporate tax rate, perhaps to 28 percent or even higher. To prevent profit shifting, such a high U.S. corporate tax would, like GILTI, have to be applied on a worldwide basis, and inversions (i.e., the nominal move of the parent corporation out of the United States) would have to be prevented. Such unilateral U.S. moves would significantly strengthen Pillar Two and persuade other countries to move in the same direction, creating a beneficial "race to the top."

Conclusion

Ruth Mason has done a tremendous job in explaining the post-2008 revolution in international tax and its broader implications to a non-tax audience. This comment sought to highlight the interaction between that revolution and U.S. rules and the likely impact of that interaction on BEPS 2.

The world faces a crucial choice in the 2020s. It can continue the retreat from globalization that began with Brexit and the election of Donald Trump. These shocks were the direct result of the failure of the system to bolster the safety net for the losers from globalization, as made all too clear in 2008-9. Or it can move in a different direction by reforming globalization, which has lifted millions out of poverty. To do so, all countries need to strengthen that safety net, especially given the current crisis, by investing more in health care, education, infrastructure, and social insurance programs. To make such investments possible, all countries need more revenue, and the success of BEPS 2 should lead to more revenue from cross-border investments being made available.

[3] Org. for Econ. Co-Operation & Dev., Public Consultation Document: Global Anti-Base Erosion Tax (Nov. 2019).