Constructive Dialogue: BEPS and the TCJA.

Reuven Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

Constructive Dialogue: BEPS and the TCJA

By Reuven S. Avi-Yonah

REUVEN S. AVI-YONAH is Irwin I. Cohn Professor of Law and Director, International Tax LLM, at the University of Michigan.

I. Introduction

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

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

II. The TCJA

The TCJA was originally driven by the desire of the U.S. MNEs to adopt a participation exemption and enable them to repatriate their "trapped income," which by 2017 amounted to about $3 trillion. This in turn was explicitly based on the fact that most other OECD countries had such an exemption, and in particular that Japan and the UK had recently switched to an exemption from worldwide taxation. Thus, in this case the 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 will compensate them from not having exempt foreign income, and (b) passthroughs wanted a rate cut to compensate them for not being corporations. The combination of these steps (the participation exemption, cutting the corporate rate from 35% to 21%, and the 199A deduction) led to massive revenue losses, and that in turn required revenue raisers to keep the 10 year cost of the overall package below $1.5 trillion, as required by the budget resolution underlying reconciliation (which was necessary to avoid a Senate filibuster). Much of the revenue came from the international provisions in the form of the one-time tax on offshore income, GILTI and BEAT, as well as the new limits on the interest deduction that apply both domestically and internationally.

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). Hopefully BEPS 2 will succeed, and the United States will then go along and amend the TCJA as well as adopt the changes envisaged in pillar 1.

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

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

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

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

Because of these and other provisions of the TCJA, it can actually be seen as more consistent with the single tax principle than previous law. On the outbound front, prior law permitted U.S.-based multinationals to accumulate over $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 following sections describe first the relevant inbound provisions of TCJA and then the outbound provisions.

a. Inbound Taxation

i. The BEAT

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

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

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

ii. Hybrid Payments

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

b. Outbound Taxation

i. Participation Exemption

New Code Sec. 245A permits an offsetting deduction of 100% for foreign source dividends received by a domestic corporation from a 10% or more owned foreign corporation. This provision is similar to the participation exemption used by most of our trading partners. It means that U.S. corporate shareholders receiving dividends from the non-Subpart F income of CFCs will not be taxed even if that income was not subject to tax at source (*e.g.*, because of a tax holiday) and was not GILTI (because it falls below the hurdle rate).

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

ii. Interest Limits

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

iii. GILTI

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

The tax rate of future GILTI is determined by taking the U.S. tax rate (21%) and allowing a deduction of 50%, for a net rate of 10.5%. This rate can be partially offset by foreign tax credits, but in a separate basket (but with cross-averaging within the basket). The section is effective for taxable years of foreign corporations beginning after December 31, 2017.

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

iv. FDII

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

Deemed intangible income is the excess of a domestic corporation's deduction eligible income (gross income without regard to subpart F income, GILTI, and other enumerated categories) over its deemed tangible income return (10% of its QBAI).

The "foreign-derived deduction eligible income" is defined as income derived in connection with (1) property that is sold by the taxpayer to any foreign person for a foreign use or (2) services to any foreign person or with respect to foreign property. In other words, this category comprises exports for property and services, including royalties from the licensing of intangibles.

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

v. Foreign Tax Credits

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

In addition, cross crediting is permitted, which creates an incentive to invest in high tax foreign jurisdictions. Assume a U.S. taxpayer with 100 income from a low tax foreign jurisdiction that exceeds the GILTI hurdle rate. If the taxpayer derives another 100 from the United States, it will pay 21 on the U.S. income and 10.5 on GILTI for a total of 31.5. But if it earns 100 from a foreign jurisdiction with a tax rate of 26.25, then it will only pay 26.25 because it will have foreign tax credits of 26.25 × 80% = 21 to eliminate its U.S. tax on GILTI (10.5% × 200).

C. THE TCJA 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 EU was charging ahead with implementing BEPS through the Anti-Tax Avoidance Directive (ATAD), the United States stated that it was already in compliance with all BEPS minimum standards and therefore other than Country by Country (CBC) reporting it had no further BEPS obligations. The United States refused to join the Multilateral Instrument (MLI) to implement

Continued on page 50

Tax Audit Trends in France

Continued from page 10

3. Criminalization of Tax Audits

One of the major recent tendencies in tax audits is the increased criminalization.

First, over the last few years, criminal penalties for tax fraud have significantly increased as well as the statute of limitations (from three to six years).

More recently, in October 2018, a significant change took place regarding the initiation of proceedings for tax fraud. Before the law on fight against fraud of 23 October 2018, the FTA, rather than the public prosecutor, had a monopoly on initiating such proceedings. Now, the FTA have to notify the public prosecutor of every case which has led to a reassessment of more than €100,000 and in which a significant penalty was imposed. A significant penalty is considered either an 80% penalty (where the, *e.g.*, a taxpayer has a hidden permanent establishment) but also where a taxpayer incurs a 40% penalty twice in a six-year period. As the FTA regularly apply the 40% bad faith penalty in tax audits in an international context, this means that if a company is audited twice within a six-year period and subject to penalties of 40%, the case will automatically be sent to the public prosecutor. Based on statistics, approximately 30% of French tax audits give rise to penalties of 80% or 40%, which means that a significant number of files could be sent to the public prosecutor. The public prosecutor then has a discretion as to whether to prosecute. It can be expected that public prosecutors would focus on the most important or more topical cases.

This recent context is leading to a change in the strategies a taxpayer may use to approach tax audits. Indeed, taxpayers are feeling more pressure and therefore more willing to negotiate with the FTA before the end of the audit to avoid their case being sent to the public prosecutor. It may also increase the likelihood of taxpayer negotiating even before a tax audit starts.

For this purpose, by a circular dated 28 January 2019, the French government has implemented a voluntary disclosure program which allows reduced penalties and the absence of automatic transfer of the file to the public prosecutor, in case of spontaneous disclosure of situations liable to an 80% penalty for hidden activity, abuse of law or fraudulent manoeuvers, in relation to international taxation (existence of an undisclosed permanent establishment, deduction of interest on loans granted by a foreign company and abusive schemes).

In a nutshell, between a rock and a hard place!

ENDNOTES

1 With turnover or gross assets equal to or in excess or 400 m€ turnover or assets, or French companies controlling or controlled by a company exceeding this threshold.

2 Advice n 429426, 429428.

Constructive Dialogue

Continued from page 28

BEPS into tax treaties, and did not join the common reporting standards (CRS) to further automatic exchange of information, leading the EU to call it a tax haven. The 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. 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. This can be seen in both the outbound and inbound provisions of the TCJA.

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

TCJA also contains two anti-hybrid provisions that directly implement the single tax principle, similarly to the ATAD. The first, Code Sec. 245A(e), disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. The second, Code Sec. 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.