U.S. International Tax Reform: How Does it Interact with the BEPS Project and Legislative Activity by Foreign Sovereigns?

ABA SECTION OF TAXATION
MAY MEETING 2015

SUBCOMMITTEE ON TAX POLICY AND SIMPLIFICATION

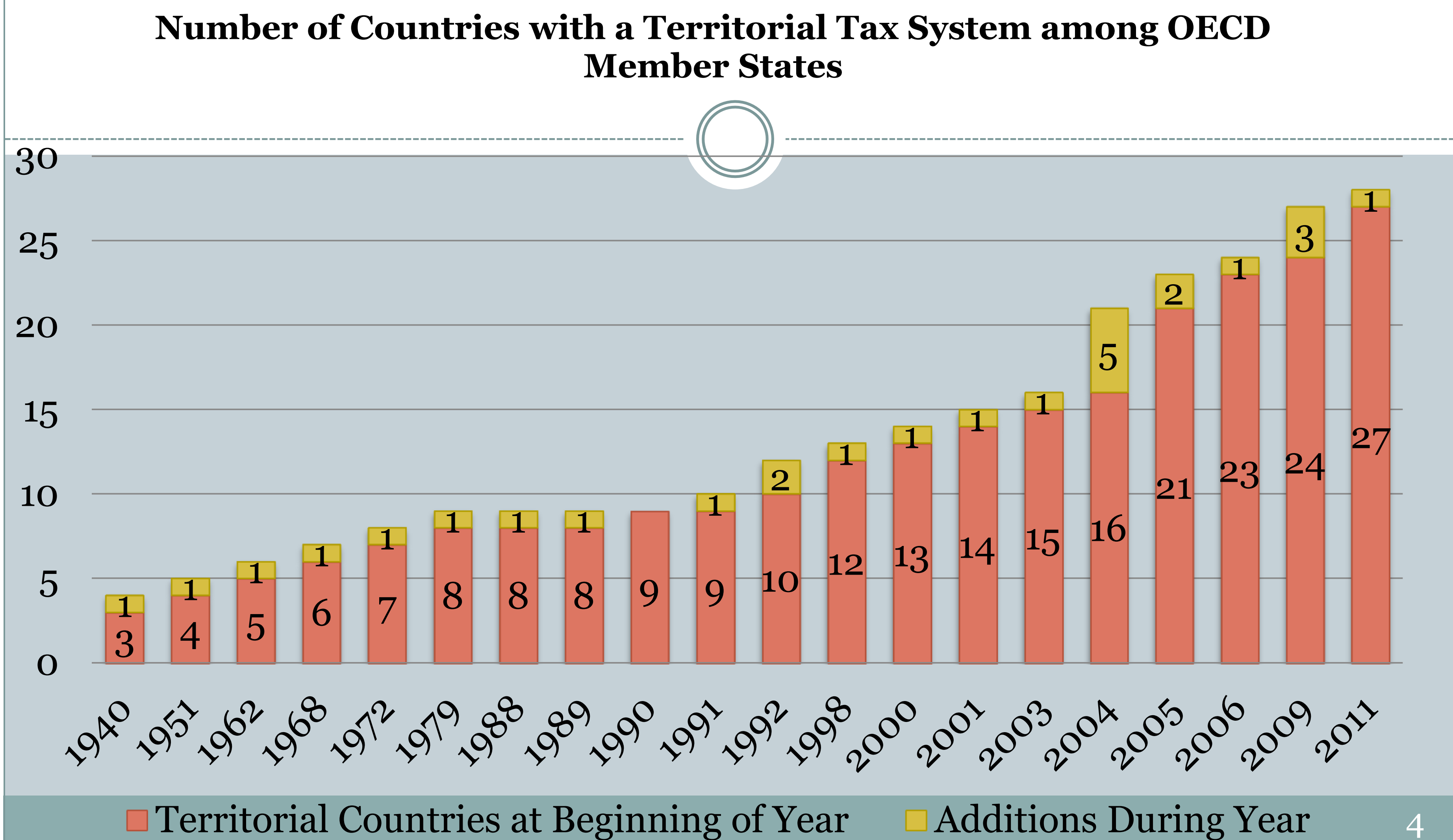
Panel Participants

- George Callas, Majority Chief Tax Counsel, House Ways and Means Committee
- Arlene Fitzpatrick, Principal, Ernst & Young
- Eric Oman, Senior Policy Advisor, Senate Finance Committee
- Itai Grinberg, Georgetown Law, *Panel Moderator*

Outline of Discussion Topics

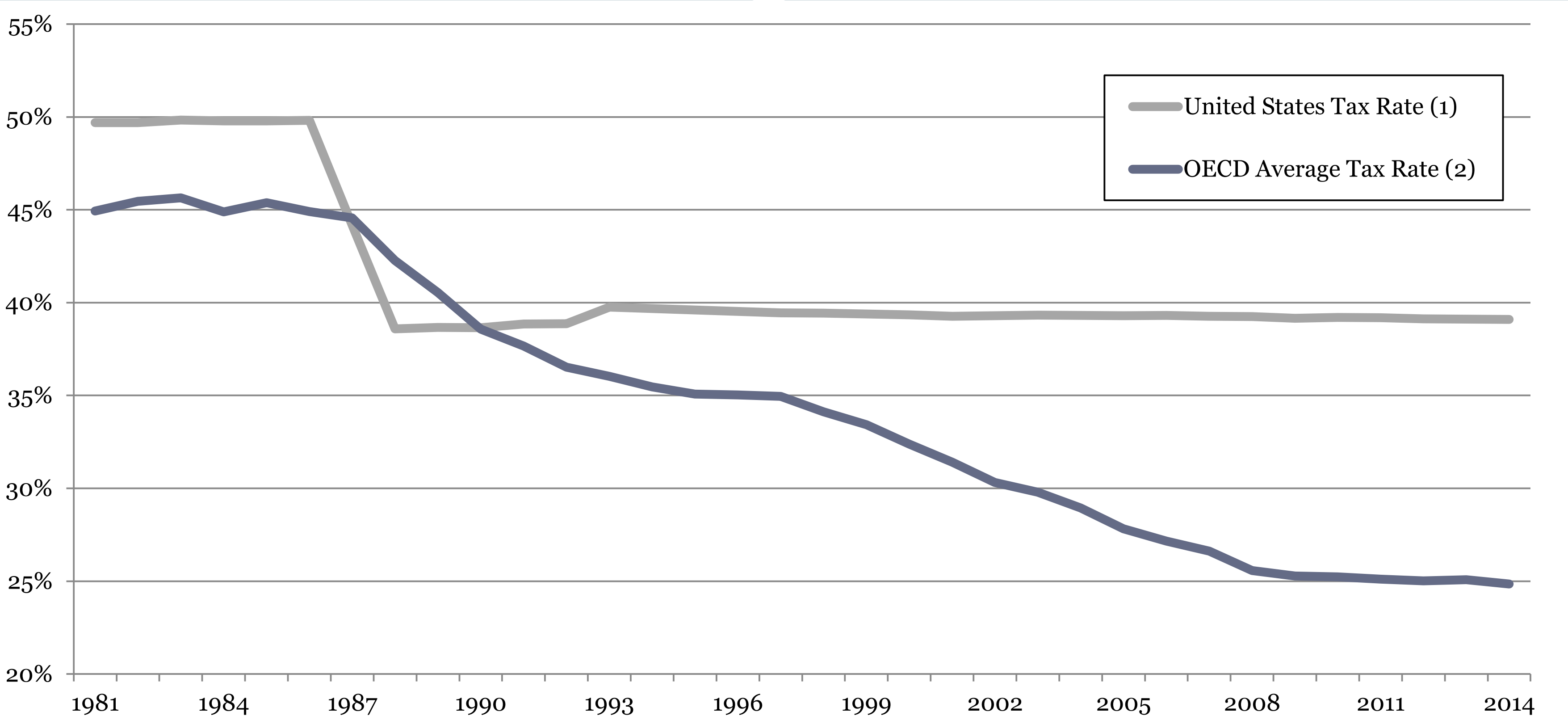
- Global Adoption of Dividend Exemption Systems and Corporate Rate Reductions
  - Impact on U.S. International Tax Reform Proposals
- Patent Boxes
- Impact of BEPS Proposals and Unilateral Actions that Increase Source Country Taxation
  - Limitations on Interest Expense
  - Lowering the Permanent Establishment threshold
    - The Diverted Profits Tax
  - Anti-hybrid rules
- Transparency
  - Country-by-country reporting and transfer pricing documentation

Territorial Systems Have Become the Norm in the Developed World



Source: *Evolution of Territorial Tax Systems in the OECD*, PwC (April 2, 2013)

Developed World Corporate Tax Rates Over Time



(1) OECD. Figure includes deduction for state and local taxes.
(2) OECD. Figures indicate the basic central government statutory corporate income tax rate, including any sub-central (combined state/regional and local) statutory corporate income tax rate, adjusted (if applicable) to show the net rate where the central government provides a deduction in respect of sub-central income tax.

US Reform Proposals: Basic Architecture

- Camp Proposal/ Tax Reform Act of 2014
  - Would Reduce Headline Corporate Rate to 25% (fully-phased in)
  - 95% dividend received deduction for eligible foreign-source dividends
  - 15% rate for income from the foreign exploitation of intangible property (whether earned by a CFC or directly by a domestic corporation). Intangible income amount determined under a formula; generally adjusted gross income above 10% of basis in depreciable tangible property.
    - Subpart F modified, including by creating a new category of subpart F for intangible income derived by CFCs (FBCII), and providing that FBCII only applies if foreign rate is below 15%.
- Administration FY 2016 Budget Proposal
  - Would Reduce Headline Corporate Rate to 28%
  - Per-country Minimum Tax Proposal
    - 19% minus 85% of foreign effective tax rate
    - Income subject to a foreign effective tax rate >22.5% fully exempt (after "allowance for corporate equity")
    - Subpart F expanded to include "digital income" and income related to manufacturing services arrangements
      - Subpart F income subject to full US corporate rate

Patent Boxes

- Intended to stimulate innovation and encourage intellectual property (IP) development.
  - Provides for an income tax reduction on profits associated with certain IP rights.
  - Targets R&D/IP investment and growth of R&D/IP
- A number of developed economies have enacted patent boxes with different design elements with respect to qualifying Income, calculation of income amount, treatment of work performed outside jurisdiction, effective date (pre and post-effective date IP), and varying relationships to other national R&D Incentives.

BEPS and the Patent Box

- BEPS Action 5: enunciated a "modified nexus" approach.
  - Under the approach, IP regime benefits are limited to income related to IP assets, understood as patents or IP functionally equivalent to patents.
  - Links the proportion of qualifying R&D-related expenditure incurred to the proportion of IP-related income that should be subject to the beneficial regime.
    - Qualifying expenditure is said to act as a proxy for substantial activity

Limitations on Interest Expense: Unilateral Actions by Foreign Sovereigns and BEPS Proposals

- BEPS Action 4
  - Current discussions said to center on a "combined approach" that would use a fixed ratio main rule, with an "escape clause" based on a groupwide allocation (keyed off EBITDA or assets).
- Unilateral Action (in advance of BEPS):
  - Previous thin cap rules in many EU countries replaced or amended by interest caps. Wide variety of rules (fixed interest/EBITDA ratio, related party/third party applicability, group-wide, various carveouts).
  - Traditional thin cap rules being tightened in other jurisdictions.
  - Other limitations on the deductibility of interest expense have been proposed/adopted among some G-20 members.

Compare US Reform Proposals for Interest Expense Disallowance

- Camp Proposal / Tax Reform Act of 2014
  - Inbound: excess interest expense threshold under section 163(j) reduced to 40% of ATI; excess limitation carrryforwards denied.
  - Outbound: Otherwise deductible interest denied if a U.S. group fails to meet both a relative leverage test defined using a 110% of US-to-worldwide debt ratio test and a 40% of ATI test. In such cases, the lesser of the two "excess interest" amounts determined under these tests is denied.
- Administration FY 2016 Budget Proposal
  - Inbound: Groupwide interest expense allocation rule based on EBITDA as reflected in financial statements, with excess net interest expense of a group member denied and a safe harbor of 10% of ATI available.
  - Outbound: Apportion interest expense to foreign-source gross income such that interest expense associated with exempt income under the Administration's min tax proposal would be denied, while interest apportioned to income subject to income subject to the min tax would be deductible only at the min tax rate.

Permanent Establishment and Similar Rules: OECD Action Plan

- Revised OECD Discussion Draft Expected
  - Earlier draft included changes to PE rules regarding
    - Commissionaire arrangements
    - Specific activity exemptions
    - Other
  - Changes to the PE threshold expected
    - Create additional nexus to tax for source states
  - Changes to the OECD Model generally highly efficacious outside the United States

Permanent Establishment and Similar Rules: UK Diverted Profits Tax

- Effective April 2015
- Separate from corporate income tax – imposed at 25% rate (vs. 20% UK Corporate Rate)
- UK asserts provision is not covered by tax treaties
- Applies when there is either: (1) Avoidance of PE or (2) Transactions Lacking Economic Substance
- "Avoidance of UK Taxable Presence"
  - Activities in the UK in connection with the supply of goods or services to UK customers by a non-UK person AND
  - sufficiently large reduction in tax liability *or* a main purpose of avoiding UK income tax
- Imposed on the profits that it would be reasonable to assume would have been attributed to the UK PE
- Not self-assessed, but a company must notify HMRC that it meets the relevant requirements
- Similar legislation being considered in other jurisdictions (Australia etc.)

BEPS and Foreign Sovereign Actions: Hybridity

- BEPS Action 2
  - Generally targets “hybrid mismatch” payments that are deductible under the rules of the country of the payor and not included in the income of the recipient (deduction/no inclusion outcomes) or that give rise to duplicate deductions as a result of a single expenditure (double deduction outcomes) .
  - Recommends “linking rules” that tie the tax treatment in one jurisdiction to the treatment in the counterparty jurisdiction, as well as certain revisions to tax treaties.
    - Primary recommended response for D/NI is to deny payer the deduction, “defensive rule” provides for inclusion by recipient
- Outbound Payments
  - Rules denying deduction for related party payments involving mismatches and/or to certain low or no tax entities have been enacted in certain countries (e.g. Austria, Mexico, Spain) and are under consideration in others (Germany, UK).
- Inbound Payments
  - EU: Parent-Subsidiary Directive amended so as to exempt dividends only to the extent those dividends are not deductible to the subsidiary.
    - France, Poland and Spain enacted legislation to implement the EU Directive amendment in 2015, one year ahead of deadline.
  - Japan similarly enacted legislation denying participation exemption where dividends are deductible in the country of the payor subsidiary.

US Reform Proposals: Hybridity

- Administration FY 2016 Budget Proposal
  - Deny deductions for interest and royalty payments made to related parties in a hybrid arrangement where there is no corresponding inclusion to the recipient or the taxpayer is able to claim an additional deduction for the same payment in another jurisdiction.
  - Treat hybrid mismatch payments received from a related person by foreign reverse hybrids owned directly by one or more US Persons as subpart F income.

ACTION 13 – CbC Reporting Template (as of September 2014): Main reporting table – country aggregated data

Tax Jurisdiction	Revenues			Profit (loss) Before Income Tax	Cash Tax Paid (CIT and WHT)	Current Year Tax Accrual	Stated capital	Accumulated earnings	Tangible Assets other than Cash and Cash Equivalents	Number of Employees
	Unrelated party	Related party	Total							
1.										
2.										
3.										
4.										
5.										
6.										
7.										
Etc ...										

ACTION 13 – CbC Reporting Template (as of September 2014): Table 2 – entity details

Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organization or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)												
			R & D	Holding or managing IP	Purchasing or Procurement	Manufacturing or production	Sales, marketing or distribution	Admin., Management or support services	Provision of services to unrelated parties	Internal group finance	Regulated financial services	Insurance	Holding shares or other equity instruments	Dormant	Other
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														
Etc ...															