Update on European and US global developments - 7th Annual IBA Finance and Capital Markets Tax Conference

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Chair
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Speakers
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Introduction

The panel addressed the European and US global developments faced by finance and capital markets. The session chair, Steve Edge, started off by asking the panellists for a brief summary of the most important current issues in each jurisdiction and very briefly what each jurisdiction has done to implement base erosion and profit shifting (BEPS) recommendations.

Steve presented the agenda: US tax reform, BEPS implementation and state aid. The first part of the session on US tax reform was the dominating topic and constituted the biggest part of the session.

US tax reform

Edward Wei started with a brief look back upon the legislative process of the US tax reform. On 22 December 2017, President Trump signed HR 1, known as the Tax Cuts and Jobs Act (the 'Bill'). The Bill represents the most significant revision to the Internal Revenue Code (IRC) in over 30 years. Many provisions are effective for taxable years beginning after 31 December 2017. The Bill is likely to be modified with technical corrections and clarified by extensive Treasury and IRS guidance in the coming month or years.

The maximum US corporate tax rate has been reduced from 35 per cent to 21 per cent. The US Senate Budget Committee (TNT 2017-999001, pp 110–111) believes that lowering the corporate tax rate is necessary to ensure that domestic corporations remain globally competitive with their counterparts domiciled in the United States' largest international competitors. The average corporate income tax rate among nations in the OECD is 22.5 per cent. The Committee noted in the Explanations (TNT 2017-999001, pp 110–111) that a low competitive tax rate also contributes to making the United States an attractive location for foreign corporations to invest. Wei observed that lowering the corporate tax rate has an impact on the choice of entity (eg, corporation, partnership), the choice of jurisdiction (eg, US, UK), accounting (write-own of deferred tax assets), private equity and hedge fund structures and M&A structures (eg, taxable vs tax-free, stock vs assets) and negotiation terms (eg, purchase price).

Wei explained that the US worldwide tax system is converted into a quasi-territorial system through the exemption of 100 per cent of the foreign-source portion of dividends (applied as a deduction) paid by a foreign corporation to a US corporate shareholder that owns ten per cent or more of the foreign corporation (the 'participation exemption'). The participation exemption requires a holding period of 366 days during the 731-day period around the ex-dividend date.

Each ten per cent US shareholder of a foreign subsidiary would be subject to a one-time tax on its share of the foreign subsidiary's historical earnings and profits (E&P) not previously subject to US tax. The 15.5 per cent rate would apply to E&P attributable to cash and the eight per cent rate to the remaining amount of E&P. E&P is determined as of 2 November 2017 or 31 December 2027, whichever is greater. Foreign tax credits may be available to offset a portion of the one-time tax and the tax liability may be paid over eight annual instalments. If a US corporation sells controlled foreign corporation (CFC) stock held for at least one year at a gain, any amount that is treated as a 'dividend' for tax purposes *may be eligible* for the participation exemption and similar rules apply if a CFC sells stock in another CFC. Wei observed that it is, however, not really clear and can be a trap for the unwary.

Pre-existing international tax regimes (eg, CFC, passive foreign investment company) have not been repealed. Beside the instruction of the participation exemption for foreign source portion of dividends, further regimes have been added (eg, GILTI, FDII, and BEAT). The Bill does not repeal IRC s 956 (part of the CFC rules), which applies when overseas earnings of CFCs are invested in US property or provide credit support for US obligor debt, resulting in a deemed dividend of earnings. These earnings that could have otherwise been distributed without US tax under the participation exemption may be subject to the 21 per cent US tax rate (less foreign tax credit). Multinational companies with cash pooling and management services and US debt issuance or credit facilities should continue to take into consideration IRC s 956 (notwithstanding the introduction of the participation exemption).

Wei explained the new regimes that have been introduced: GILTI, foreign-derived intangible income (FDII) and base erosion anti-abuse tax (BEAT). A US corporation would be subject to a 10.5 per cent US tax (increased to 13.125 per cent beginning in 2026) – *assuming 0 per cent foreign tax rate* – on the global intangible low-taxed income (GILTI) earned by its CFCs, which is the amount of income of the CFCs that exceeds an implied ten per cent rate of return on their tangible business assets (as determined by their tax basis). Since only 80 per cent of foreign tax credits are allowed to offset US tax on GILTI, the minimum foreign tax rate with respect to GILTI at which no *US residual tax* is owed by a US corporation is 13.125 per cent. While the GILTI regime ostensibly addresses the migration of intangible assets out of the US to low-tax jurisdictions, Wei explained that the regime potentially also addresses the concern that any profits shifted abroad would permanently escape US taxation with the participation exemption and thereby exacerbate base erosion incentives. GILTI would be included in the US shareholders' income each year without regard to whether the amount was distributed by the CFC to the US shareholder.

Wei moved then to the FDII: a US corporation is subject to a reduced 13.125 per cent effective tax rate between 2018 and 2025 after permitted deductions (16.406 per cent effective tax rate beginning in 2026) rather than the new 21 per cent corporate tax rate, on FDII. FDII is generally intangible income of a US corporation from foreign sales, including licences and leases, that is for foreign use and foreign services that exceeds an implied ten per cent rate of return on its tangible business assets (as determined by their tax basis). Wei observed that the preferential FDII rate for foreign-derived intangible income presumably is intended to encourage US corporations to keep production activities in the US. The preferential regime applies more broadly than only to patents. It has to be considered whether the 13.125 per cent FDII rate and the 21 per cent US corporate tax rate are sufficient to incentivise the move of foreign intellectual property to the US after considering transactions cost. It also has to be considered whether the FDII provision violates WTO obligations (as an illegal export subsidy) or implicates any tax treaty or other non-tax issues. The FDII provision may be further analysed with regard to patent boxes in other jurisdictions (compare/contrast) and BEPS Action 5 (Harmful Tax Practices).

Wei continued with BEAT: a five per cent (increased to ten per cent in 2019 and to 12.5 per cent in 2026) minimum tax would be imposed on US corporations calculated on a modified tax base that excludes ‘base erosion payments’ made to related parties. The BEAT tax liability is the excess of the BEAT tax rate times the modified tax base over the regular tax liability. BEAT would only apply to corporations with average annual gross receipts of at least $500m, at least three per cent of whose deductions are derived from payments made to related foreign parties. Base erosion payments include any amount paid or accrued by a taxpayer to a related foreign person for which a deduction is permitted or in connection with the acquisition by the taxpayer or depreciable property (eg, interest payments on inter-company loans or royalty payments). The Treasury has broad authority to issue regulations to prevent avoidance of the base erosion minimum tax, including through conduit transactions. Wei observed that intra-group financing, cash management structures, IP structures and inter-company transfer pricing arrangements should be evaluated. The BEAT provision may override US tax treaties, including the non-discrimination article of US tax treaties (restricting tax benefits based on nationality of recipient without regard to the arm’s-length principle).

Deductions for net interest expenses for all business entities would be limited to 30 per cent of the business’s adjusted taxable income (as defined similar to earnings before interest, taxes, depreciation and amortisation (EBITDA)). Any disallowed interest expense may be carried forward indefinitely. The new provision would apply to interest paid to anyone. There is no grandfathering for debt issued before 2018. Wei noted that this provision appears to disadvantage highly-leveraged firms and firms that may be distressed. Financing structures should be re-examined to take into account the new provision, including whether incurring debt at foreign entities would yield a better global tax result. The 30 per cent limitation on interest deductions may be to be further analysed with regard to BEPS Action 4 (Limiting Base Erosion Involving Interest Deduction and Other Financial Payments).

The Bill 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 if there is no corresponding income inclusion under local tax law or the related party is allowed a deduction under local tax law. The new provisions cover only interest and royalties. The Treasury is expected to issue guidance regarding rules addressing conduit arrangements, use of branches and definition of tax residence. The new provision may have to be further analysed with regard to BEPS Action 2 (Hybrid Mismatch).

Dutch tax reform

Margriet Lukkien started with the most important current tax developments in the Netherlands: on 10 October 2017, the new Dutch government announced as part of its tax plans that it would partially abolish the dividend withholding tax (DWT) at the level of Dutch companies by 2020. Lukkien observed that this is good for headquarter companies and MNEs listed in the Netherlands. The current DWT is 15 per cent with various exemptions. According to the tax plans, there would be still a DWT due on dividend distributions in case of abuse (eg, letter-box companies) and/or dividend payments to low-tax jurisdictions. The tax plans include the introduction of interest and royalty withholding tax, which does not currently exist in the Netherlands. These new rules would apply to interest and royalty payments to low-tax jurisdiction and/or in case of abuse. There is a further plan to lower the corporate tax rate gradually to 21 per cent by 2021. The current rate is 25 per cent.

Lukkien continued with the Dutch status on BEPS implementation. The Netherlands implement country-by-country reporting, master file and locale file, both in line with the BEPS Action 13 and applicable as of financial year 2016. The innovation box provides beneficial tax treatment of certain R&D income and capital gains. The modified nexus approach focuses on functions and activities self-performed rather than outsourced to affiliated parties. The Netherlands will implement the modified nexus approach in line with BEPS Action 5 and applies as of financial year 2017. The Netherlands expects 44 of its tax treaties to be affected by the Multilateral Instrument (MLI). On 22 December 2017, the Dutch government submitted the bill for MLI ratification to the parliament. Lukkien noted that the Netherlands accepts, in principle ,all substantial MLI provisions. The Dutch government intends to complete the ratification procedure in the first half of 2018, so that the MLI may have effect for tax treaties concluded by the Netherlands as of 1 January 2019 depending on the ratification by its treaty partners. Lukkien continued with the EU Anti Tax Avoidance Directive (ATAD). In July 2017, the Netherlands published for consultation preliminary draft proposals to implement ATAD (the 'Preliminary Proposals'). Release of the legislative proposals is expected in the first quarter of 2018. The Preliminary Proposals address CFC taxation rules, interest deduction limitation rules, exit taxation and GAAR in order to bring legislation in line with the ATAD. The Preliminary Proposals do not have hybrid mismatch rules in line with ATAD. The Proposals will probably be realised in 2018 and only to be implemented as of 2020 and for reverse hybrid entities as of 2022.

Lukkien discussed Dutch tax reform in the light of the competition in Europe for businesses and holding companies. The Netherlands has changed its DWT rules as of 1 January 2018. A DWT obligation was introduced on distributions by holding cooperatives, that is, cooperatives with activities consisting of more than 70 per cent of holding participations and/or of group financing activities. A new DWT exemption was introduced for Dutch entities held by companies resident in a state with which the Netherlands has concluded a tax treaty including a dividend article (as an extension of the current DWT exemption for EU situations). Lukkien illustrated this new provision with the following example: the dividend distribution to a Canadian parent was so far subject to 15 per cent DWT or lower rate of five per cent under the NL-CAN tax treaty. Under the new rules, the distribution is not subject to DWT. The anti-abuse test to which the DWT exemption is subject has been revised (Principle Purpose Test, Business Reason Test). These new rules are considered to be in line with the MLI PPT and EU Parent Subsidiary Directive GAAR.

Developments in Italy

Bernadette Accili started with a brief summary of the Italian government's implementation of ATAD and BEPS recommendations. The Italian government has been authorised to implement the ATAD Directive. The implementation act has to become effective by 31 December 2018. The current Italian law provided provisions for interest deduction (in line with BEPS provision), hybrid mismatch (substantially in line with BEPS provisions, some amendments required), CFC (has to be amended) and GAAR (in line with BEPS provisions). Accili further discussed developments in Italian capital market law (eg, securities law, investment plans).

Finally, Accili discussed state aid investigations in the EU and the types of allegations encountered. The allegations are transfer pricing arrangements (Luxembourg: Fiat Chrysler, Amazon; Netherlands: Starbucks), the profit allocation method (Ireland: Apple), excess profits tax scheme (Belgium: more than 35 multinational enterprises), double non-taxation (Luxembourg: McDonald's, GDZ Suez), licence fee, purchase price intellectual property rights, interest paid for inter-company loan (Netherlands: Inter IKEA Systems). Accili further held that the Italian tax authority opened formal investigation against some MNEs where allegations consist of maintaining a permanent establishment in Italy.

Implications of Brexit in the UK

On the UK tax impact of BREXIT, Steve Edge said he thought there would be few (if any) consequential changes to the UK tax system established when the territorial system had been created a few years ago. EU driven changes would not be reversed. The UK would still try to be competitive on inward investment (with a relatively low rate on corporate income), would not impose withholding tax on outbound dividends and would continue to benefit from its extensive range of double tax treaties providing relief from withholding taxes and so on. So, the UK would retain its attraction as a holding company location. On the commercial activity side, VAT on cross-border flows was obviously going to be an issue needing a solution. As regards the financial centre, his assessment was that the consequences of losing free access to European markets was not going to be as bad as had been feared.

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