US Tax reform – Penalizing Intra-Firm Imports

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Johannes Becker, Joachim Englisch (University of Muenster)

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In mid-November, the Republican majority in the US House of Representatives has passed its version of the Tax Cuts and Jobs Act bill. Last Saturday, the Senate has followed suit and has cast a 51:49 approval vote on the parallel tax reform bill introduced by its Republican members. Admittedly, it is still not entirely clear whether the progress made so far will allow President Trump to sign his signature reform project into law before Christmas. The two versions of the bill still need to be reconciled, and an eventual compromise requires the approval of both chambers of Congress. However, prospects for success have now improved considerably, not the least because stakes are high for Republican members of Congress facing re-election in 2018. The rest of the world should therefore brace itself for massive implications that the reform will have for global trade and the international tax system.
Both, the House and the Senate version of the reform project contemplate a switch from the current system of worldwide taxation to a system of territorial taxation. That means that in the future, income of US firms would only be subject to US tax if sourced within US borders. Repatriated foreign earnings would no longer be taxed.

By waiving its right to tax income generated outside of US territory, the US would become more vulnerable to profit shifting and other forms of manipulation in order to avoid US taxation. As one countervailing measure, the Republican tax plans propose a limit on interest deduction (similar to the interest barrier rules implemented by Germany and other European countries). In addition, both versions provide for anti-base erosion measures that would effectively penalize intra-firm imports into the US.

The House plan: an “excise tax” on intra-firm imports

In the House version, multinational firms would have to pay an “excise tax” on virtually all imports from related parties abroad (if deductible payments exceed USD 100 million on a three-year average). The excise tax rate is applied on the gross payments for imports, it is not deductible from the corporate tax base, and it is paid by the importer located in the US. Its rate is 20 per cent and, thus, equal to the envisaged new corporate tax rate. Therefore, the excise tax has the same effect as if deductibility of imports were completely denied (as the reduction in the US corporate tax base is compensated by an increase in the excise tax base dollar-for-dollar).

In fact, the excise tax is what remains from the highly contentious plans for a „Border Adjustment Tax“, which have been dropped earlier this year after massive lobbying against them. However, whereas the Border Adjustment Tax would have been part of a coherent and fundamental reform towards a destination-based tax system, the excise tax has the more modest goal to curb tax avoidance by profit shifting. The excise tax ensures that within its ambit, MNEs no longer have an incentive to manipulate transfer prices to shift profits abroad. Its desired effect implies an asymmetric design, though: Whereas imports are subject to the excise tax, intra-firm exports are not. It is probably not a coincidence that this inherent limitation also chimes well with “Trumponomics”.

According to the House proposal, the excise tax can be averted by electing to treat the amount that would otherwise be subject to excise taxation as earnings effectively connected with the conduct of a trade or business in the US, carried out through a (fictitious) permanent establishment located within the US. As a consequence, the foreign exporting unit of the MNE would have to pay regular US corporate tax on this income. It would then be able to deduct a standardized percentage of its overall production costs for the respective category of exported goods or services as “deemed expenses”.

Seemingly after an intervention of multinational businesses and foreign governments, the House Ways and Means Committee has furthermore softened the reform bill’s initial position on a foreign tax credit in this context. While originally none was provided for, an amended version of the bill that was subsequently endorsed by the House Republican majority allows for an ordinary credit of up to 80 per cent of foreign taxes paid or accrued with respect to the amounts taxed in the US. However, this credit is granted only if the multinational firm accepts for the corresponding export activity to have nexus with the US. Revenue-wise, this concession is costly, and it moreover implies complex calculations. Its discreet charm lies in its more targeted approach against base erosion schemes: Imports from related parties located in high-tax jurisdictions like Germany or France would be spared from an additional US tax burden (as 80 per cent of e.g. the German 30 per cent tax rate would exceed the envisaged US corporation tax burden of 20 per cent), because the risk of artificial profit shifting into such jurisdictions is low. By contrast, regarding intra-firm exports to the US from low-tax jurisdictions with a high base erosion potential such Ireland, the tax burden on any earnings would still increase sharply.

The Senate proposal

The Senate version of the Republican reform proposal takes a similar stance towards intra-firm imports, but it differs markedly regarding the scope, technical design and the proposed tax burden. The Senate bill seeks to impose a "minimum tax" on profits of US companies or permanent establishments that belong to a multinational firm with more than USD 500 million annual turnover (three year average). The minimum rate for this "Base Erosion Anti-Abuse Tax (BEAT)" would be set at 10 per cent (12.5 per cent as from 2026 onwards) on intra-firm imports, in addition to the regular US corporate tax burden. However, it would only apply to the extent that intra-firm payments reduce taxable profits in the US by more than a half. Moreover, the cost of imported current assets (in particular, costs of goods sold and inventory costs) are disregarded, except in certain cases involving corporate inversions. The Senate bill furthermore provides for a *de minimis* exception: If the deductible cost associated with the imports from foreign related parties does not exceed 4 per cent of the total amount of expenses incurred by the respective US affiliate or PE, the minimum tax is not levied. Finally, payments that are already subject to regular US taxes, such as e.g. withholding taxes on certain royalty payments, will not be taken into account for the purpose of calculating the minimum tax.

Like the House version, the Senate version thus denies full deductibility of payments for imported IP, services and know-how, though only partially and only above a certain threshold. However, the Senate version does not extend the additional tax burden to all imports of goods; as a general rule, only the import of fixed assets is subject to minimum taxation. On the other hand, the concept favoured by the Senate does not include the possibility to credit foreign taxes against the minimum tax. Altogether, the Senate version is simpler and implies lower administrative and compliance costs, but it is less effective in terms of curbing overall profit shifting. The Senate Republicans are apparently more concerned with preventing outbound profit shifting and base erosion that relies specifically on the exploitation of intangible property. This is underlined by additional provisions in their bill that would effectively impose a minimum tax of 10 per cent on CFCs to the extent that the latter are presumed to earn "global intangible low-taxed income" (GILTI)". By contrast, the House Republicans tackle the phenomenon on a broader scale, but are more focused on outbound payments.

European viewpoint: Risks of double taxation and base erosion

Both the House and the Senate version imply large risks for European firms. While the intention to aggressively deal with tax-induced profit shifting is shared by many EU governments, there are important downsides associated with the reform proposals. The United States would unilaterally abandon the widely accepted (though imperfect) system of source taxation based on the arm's length principle. As a consequence, income generated in multinational firms from intra-firm imports into the US would often suffer from double taxation: in the EU, such income would be subject to regular corporation tax in accordance with established international tax law principles, and in the US, an additional excise tax or (minimum) corporation tax could apply. This is bad news for all European firms with subsidiaries or fixed establishments in the US; they would be hit with non-negligible tax cost hikes.

In particular, should the Senate approach of a minimum tax without foreign tax credit eventually prevail, this would be a concern also for high-tax jurisdictions such as Germany. Since income is only double taxed when it is generated and accounted for in Europe, firms would have a strong incentive to shift profits to the US (where after the reform, they would furthermore be taxed at a lower rate, anyways). This could be done by manipulating transfer prices such that book profits increase in the US and decrease in Germany. Alternatively, real economic activity (in particular, service and research units) could be relocated to the US – which would be even worse for the European economies.

An especially strong pull to the US would be on research units and research outcomes like patents and other intangible assets. Not only would a transfer to the US avert the danger of international double taxation of royalties, licence fees etc, that would otherwise be paid to the extent that the intangibles are exploited in the US (and would therefore potentially be subject to excise tax or minimum tax). The Senate reform package includes an “IP box light”, granting reduced taxation for income deemed to have been derived from the exploitation of US-based intellectual property abroad. Seemingly, this privileged treatment would also be made available to IP that was initially created outside the US, ignoring the OECD recommendations made in the final report on BEPS Action 5 (modified nexus approach). Due to the combined carrot and stick approach, the US would thus become an attractive R&D and IP location, while limiting potential revenue losses to foreign earnings that might otherwise never have come within their fiscal reach, anyways.

An upside for high-tax jurisdictions (like Germany)

It should be noted, though, that high-tax jurisdictions such as Germany might indirectly benefit from the House version of intra-firm import taxation. The partial foreign tax credit envisaged in the House bill would increase the tax on exporting firm units in low tax jurisdictions but it would leave the overall tax burden for firm units based in high-tax jurisdictions unaffected. For both, European and US multinationals, Germany would thus gain in relative attractiveness compared to e.g. Ireland. This might have the consequence that e.g. German based MNEs do not use the detour via Ireland anymore and relocate their Irish subsidiaries back to Germany. Another consequence could be that the Irish government finally agrees to an increase in its corporate tax rate – since the partial credit makes a tax increase less costly to the firms already located in Ireland.

Europe must act

In the US, there is growing skepticism against the proposals for an excise or a minimum tax. The reason is that US multinational firms importing from abroad are affected by the tax as are their European counterparts. However, it is unlikely that the resistance will be as strong as in the case of the proposal for a border adjustment tax which has been discussed earlier this year. Above all, the US retail sector – one of the most powerful opponents of the border tax – mostly uses imports from unrelated parties and is thus unaffected by the anti-base erosion components of the respective reform bills.

European governments and lobby groups must therefore muster their own resources to prevent the US Congress from introducing these taxes – or at least mitigate the consequences. Besides relying on political pressure, some legal arguments could be advanced, too: The proposed excise tax is quite clearly equivalent to an import tariff that will in many instances contravene the obligations of the US under world trade law (especially with respect to the import of goods). The ensuing *de facto* denial of deductibility of import costs is, moreover, in contradiction to the non-discrimination clauses the US has included in its double tax agreements with its trading partners (inspired by Art. 24.4 OECD model tax convention). The alternative of taxing the amounts at issue as income of a fictitious US permanent establishment arguably ignores the territorial limits imposed on corporate taxation of business profits, as enshrined in Art. 5 and 7 of the relevant tax treaties. Finally, the Senate version of taxing intra-firm imports would imply a treaty override as well; depending on the individual case at hands, it would be in contradiction to treaty provisions implementing Art. 7 or Art. 9 OECD model tax convention. Besides, the Senate's plan to offer a low tax IP regime for foreign-derived intangible income also regarding the earnings from the sale of property (deemed to have been manufactured using domestic IP) is liable to contravene the WTO prohibition on export subsidies for goods.

The EU Member States could respond to these violations of international law by applying countervailing measures. In a WTO context, this would be done by imposing punitive tariffs, whereas a reaction to treaty overrides could be the reciprocal denial of advantages to US based firms, or even the cancellation of existing DTCs. It is important to convince the US policy-makers that such an escalation risk is real and in nobody's interest. It is unfortunate that at this crucial moment, Europe's biggest economy and the world's leading exporter, Germany, is inward-focused and struggling to form a stable government.

The OECD must propose a system fit for the 21st century

From a broader perspective, the question arises whether the traditional understanding of source based taxation is still the best fit for a digitalized economy. The currently debated excise tax or minimum tax concepts are merely particularly broad proposals within a series of attempts, mostly by large jurisdictions or trading blocs, to implement alternative solutions that deviate from the OECD recommendations. Already some years ago, the UK introduced its diverted profits tax, and is now contemplating to impose significant withholding taxes on the earnings of large non-resident internet firms. In the US, the Ryan blueprint (Summer 2016) favored the switch to a destination-based corporate tax system with border adjustment. In September 2017, a group of EU finance ministers proposed an "equalization tax" on the turnover of (mostly US based) firms of the digital economy; a move that India, for example, has already made. These proposals might eventually not materialize, but they reflect the growing discontent with the current system of international taxation. Despite the coordinated efforts of recent years, especially within the institutional framework of the OECD BEPS project, this system is still vulnerable with regard to manipulation. Arguably, it also lacks appropriate nexus criteria and profit allocation formula that would adequately capture the value creation under the business models of the digital economy, that rely heavily on intangible property and big data analytics. The US proposals in particular are nothing short of a no-confidence vote against the OECD Transfer Pricing Guidelines, even after their amendment in line with the relevant BEPS reports.

The OECD must come up with coherent, robust and balanced concepts for a fundamental reform of the international tax system soon; the interim report on the digital economy due in spring 2018 provides an opportunity. If the organisation fails to deliver, it will be hard to put the genie back in the bottle and prevent the fragmentation of the international consensus on the allocation of taxing rights in accordance with commonly agreed principles. Especially in high-tax jurisdictions, the idea of a unilateral imposition of additional taxes on firms that avail themselves of low-tax jurisdictions or preferential regimes is gaining traction fast. If the US sets new standards in this regard, others will surely follow suit quickly, with potentially grave implications for global trade and economic growth.