The Great Recession and the International Tax Regime

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Reuven S. Avi-Yonah (University of Michigan)

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The financial crisis of 2008 and the Great Recession that followed led to millions losing their jobs and their homes. In Europe, the governments reacted to the pressure on the Eurozone by imposing austerity and sharply cutting the social safety net. While the Obama Administration made no such cuts, the size of the US fiscal stimulus was too limited, and while the banks were saved millions of Americans suffered a decade of low growth and unemployment.
The political reaction on both sides of the Atlantic was dramatic. It led directly to Brexit, the election of Donald Trump in the US and of other right-wing populists in the EU, and the prospect of serious limits to globalization in the form of immigration restrictions, tariffs, and the re-enactment of exchange controls. The nation state was reasserting itself, and one of the instruments it used was taxation. In the US the focus on taxation was limited to the first couple of years after the crisis, since the Republican takeover of the House in 2010 meant that no tax measures could be enacted before 2017. But in Europe austerity meant a continued political focus on taxing both the rich and MNEs.

The result has been a series of developments that led to a significant enhancement in the ability of the international tax regime (ITR) to capture cross-border income.

The first was the OECD Base Erosion and Profit Shifting (BEPS) project (2013-15), which was led by the G20 and resulted in fifteen action steps designed to enhance both source and residence based taxation of active income. For example, BEPS Action 2 bars a deduction for payments to hybrid entities, thereby eliminating the impact of check the box.

BEPS was introduced in the EU as the Anti-Tax Avoidance Directive (ATAD), which generally came into effect in January 2019 and which among other measures requires all EU members to adopt strict CFC rules (e.g., generally requiring residence-based taxation if the effective tax rate of the source jurisdiction is below 50% of the tax rate in the residence jurisdiction). This measure, in addition to the enactment of BEPS Action 2, means that it is much harder now to shift profits artificially out of EU member states. Another important measure in BEPS and ATAD is the primary purpose test (PPT), which requires that all tax treaties incorporate language that the treaty will not apply to transactions if a primary purpose of the transaction was tax avoidance.

Until 2017, it could be argued that the US was a laggard in terms of combating tax avoidance, because it took the position that it was already compliant with BEPS, rejected the PPT, and did not sign the MAATM. But the 2017 tax reform (TCJA) dramatically changed that. TCJA includes three measures that significantly increase taxation of US-based as well as foreign-based MNEs. First, TCJA imposed a one time, hefty transition tax on the $3 trillion of past, accumulated earnings of US-based MNEs. Second, while TCJA provided for an exemption for certain future dividends from CFCs to their US parents, this exemption is strictly limited to a deemed 10% return on tangible property, which for most US-based MNEs is close to zero (because they rely heavily on intangibles). For any amount that exceeds this deemed return, TCJA imposes a current minimum tax of 10.5% (13.25% if foreign tax credits are included) on worldwide earnings of the MNE. Third, TCJA imposes an alternative minimum tax of 10% on both US- and foreign based MNEs by disregarding interest, royalty and some other payments from the US to the related foreign entity.

The result of these developments (BEPS, ATAD and TCJA) is that both US and foreign MNEs are likely to be subject to significantly higher levels of tax on cross-border active income than they were before 2008.

To give an example: The structure used by most US-based MNEs before 2017 for their foreign operations was to have a top level CFC in a low-tax jurisdiction, with lower-tier CFCs in high tax jurisdiction. The parent would transfer intellectual property to the top CFC via a cost sharing agreement, and the top CFC would in turn would license the IP to the lower-tier CFCs. The key to this structure was that under check the box, only the top CFC would be treated as a corporation, while all the lower CFCs would be disregarded (i.e., treated as branches of the top CFC). As a result, while for foreign tax purposes deductible royalties from the lower CFCs to the top CFC would be effective in shifting profits to the low-tax jurisdiction of the top CFC (and not subject to withholding under treaties), for US tax purposes these royalties did not exist and so did not trigger a deemed dividend to the US parent. In addition, deductible cost sharing payments could be made from the US parent to the top CFC.

This structure does not work any more, for three reasons. First, under BEPS Action 2, as implemented by the EU ATAD, the royalties from the bottom CFCs to the top CFC would not be deductible because they are to a hybrid entity. Second, the cost sharing payments from the US parent to the top CFC would be subject to the BEAT minimum tax. And finally, the top CFC as well as all the disregarded entities below it would be subject to the GILTI minimum tax (10.5% or 13.25% with foreign tax credits) on a current basis. The result is that US-based MNEs need to restructure their foreign operations and are likely to be subject to a significantly higher worldwide effective tax rate than before 2018, despite the fact that both check the box and IRC section 954(c)(6) have not been affected by the TCJA.

In 2000, I predicted that unless something was done about limiting tax competition, there would be a retreat from globalization and a revival of nationalism. This has now happened, in the form of restrictions on immigration and renewed tariffs and exchange controls. Increased nationalism could even lead to a new world war.

The last decade has seen significant limits to tax competition. But in order to prevent further political damage, more needs to be done. First, additional changes to bolster the ITR are required. Second, the added revenues should be used to bolster the social safety net and prevent another Great Recession.

There are two additional measures that I believe would strengthen the ITR.

1. In regard to active income, there are a limited number of residence countries of MNEs (over 90 of the Fortune 100 are resident in the G20). If all the G20 could agree to further strengthen CFC rules to eliminate exemption or deferral, most MNE income would be taxed currently. In the US this would mean that the GILTI provision should be revised to eliminate the 10% deemed return exemption and increase the rate to 21%. Strict anti-inversion rules (e.g., a managed and controlled residency test) would eliminate the ability of MNEs to artificially move out of the US.

2. Since active income should be taxed at source, and since tax competition does not affect the market jurisdiction, the EU proposals for eliminating the PE standard and substituting a virtual PE threshold for "significant digital presence" should be adopted. In addition, a formula should be used to allocate residual profits under the arm's length standard between source jurisdictions. These ideas were both broached by the OECD and are likely to be adopted soon. The key issue is that the US and other G20 countries should grant foreign tax credits to such taxes. The fact that most G20 countries have similar tax rates should make such FTCs acceptable.

What should be done with the added revenues? I believe the first and necessary step would be to enhance the social safety net that was deeply hurt by the Great Recession. In the US, this requires universal health insurance, additional investment in education, and a massive infrastructure program.

The world faces a crucial choice in the 2020s. We can either continue retreating from globalization in favor of xenophobic nationalism, tariffs, immigration restrictions, and exchange controls. That road leads ultimately to war, as it did in the 1930s. Or we can revive globalization by investing in a robust social safety net, infrastructure, education, and job creation. While more needs to be done, we have made significant progress in curbing tax competition in the last decade. The key move now is to take the added revenue and invest it wisely.