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International Tax Newsletter

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The Prospects for Tax Reform in Trump Town

Matthew Cutts and Brandon Román

With the 115th Congress nearing the end of month two, tax reform continues to be a focal point of the political debate in Washington DC. Intent to move forward with their tax reform "Blueprint" released in June 2016, Speaker Paul Ryan (R-WI), House Ways and Means Committee Chairman Kevin Brady (R-TX) and other high-profile tax-writers have spent a significant amount of time and energy in recent weeks promoting their proposal, which would dramatically overhaul the US tax system and make significant reforms to the Internal Revenue Service (IRS). Though initial expectations were that the text of the Blueprint might be available as early as March, Chairman Brady has since indicated that he now hopes to have the legislation released "during the first half of the year," which likely means that the text of the bill will be finalized by June of this year.

Once the legislation is drafted, it will then be taken up and debated by the Ways and Means Committee – a process that will likely be contentious given the current political divide in Washington DC. That divide, however, is not solely a partisan one; signs of GOP discontent can be seen in the Senate (and, according to our sources, can also be seen even among House Ways and Means Republicans) and could potentially extend to the White House. The main issue dividing Republicans at the moment is the Blueprint's Border Adjustable Tax (BAT), which would essentially: (1) disallow deductions for imports when calculating cost of goods sold and (2) exclude revenues earned from exporting goods from taxable income.

Though Senate Republicans have generally avoided opposing BAT outright, several influential senators have either expressed concerns about the proposal or indicated that they have doubts and are thus, withholding judgment. Perhaps the most vocal opponent of BAT to date has been Senator David Perdue (R-GA) who recently sent around a "Dear Colleague" letter arguing that the BAT is "regressive, hammers consumers, and shuts down economic growth." In addition, opposition in the Senate appears to be growing. In fact, concerned about the rhetoric coming out of the Senate on the BAT, Speaker Ryan recently began outreach to Republican senators, urging them to "keep their powder dry." Reports suggest that his visits have not been well-received and are, at best, having minimal impact in the Upper Chamber. Notably, despite the most recent efforts by the Speaker, the skepticism in the Senate seems to be growing, with Senate Finance Committee Chairman Orrin Hatch (R-UT) just this week acknowledging he "[does not] see [BAT] happening, not the way the House has configured it."

At the White House, a group of the nation's largest retailers (who oppose BAT) recently met with President Trump to discuss the BAT and its negative implications for businesses and the economy. Though the President walked back his earlier comments suggesting that the BAT may be overly complicated, he has at the same time failed to fully embrace the concept (or at least the concept as proposed in the Blueprint). Notably, though, the Trump administration plans to release an outline of its "phenomenal," comprehensive and bipartisan tax reform proposal in the next several weeks (likely by March 14, 2017) as part of its FY 2018 budget proposal. The process of putting together such a proposal is something that will benefit from the recent confirmations of Treasury Secretary Steven Mnuchin and Director of the Office of Management and Budget Mick Mulvaney. While nothing has yet been finalized, it appears that President Trump may be more in line with the Senate in questioning whether a BAT is appropriate and effective. That said, there appears to be a divide even within the White House, with the political staff favoring the BAT and the policy staff generally opposing it. How the President ultimately addresses BAT in his budget will be critical to whether the BAT survives.

In terms of timing for reform, much will depend on the success of the House Blueprint. Assuming the proposal moves forward largely as is, the House is aiming to wrap up debate and successfully enact tax reform by August. That said, the likelihood that final action on

tax reform – if it happens – slipping until the end of the year appears to be a possibility growing more likely by the day, as the politics of tax reform seem to be slowing the process.

Importantly, as was originally brought to our attention in December 2016 – and as is becoming clearer with every passing day – Senate Finance Committee members are not wedded to the Blueprint. As such, the Committee is proceeding as if it may need to present its own bill, with Republican GOP staff meeting *en bloc* to understand the real-world impact of the Blueprint. Thus, we can expect that, at a minimum, the Committee will take up and significantly amend the Blueprint. As noted above, however, it is also possible that the Senate may be positioned to move its own tax reform bill – legislation that we imagine would likely not contain a BAT.

It is also important to note that, unlike their House counterparts, Senate Democrats have the potential to wield significant influence over the tax reform process – especially given the makeup of the Senate (52 Republicans and 48 Democrats/Independents) and the fact that 60 votes are needed to pass legislation through regular order. While the Senate Democrats have pushed back on the Blueprint (e.g., the Senate Democratic Finance Committee staff memo released in December 2016), calling it regressive and urging Republicans to fill out the details, they have nevertheless pledged to work with the GOP in an effort to come together on a solution that both parties can support.

While this all adds extra pressure to accomplish tax reform on a bipartisan basis, Republicans have the fallback option of reconciliation – a fast-track procedure (i.e., requiring only a simple majority) designed to facilitate changes in laws governing, among other things, revenues to achieve certain budgetary goals reflected in a budget resolution. Doing tax reform under reconciliation, however, also comes with certain drawbacks, as it cannot add to the deficit in any year outside the 10-year budget window. As currently drafted, this would likely require sunsetting at least portions of the tax policy changes called for in the Blueprint – something Republicans want to avoid if possible. Nevertheless, Republicans do not want to miss the opportunity to lower rates, thus – as Senate Majority Leader Mitch McConnell (R-KY) continues to remind his fellow senators – reconciliation remains a real possibility if lawmakers cannot come to agreement on a bipartisan bill.

In sum, key policymakers remain committed to seeing tax reform across the finish line this year. With many consequential tax policy issues yet to be decided, however, the path to tax reform is growing more uncertain. In particular, if proponents of tax reform let too much time slip away, they will soon find themselves running up against the 2018 Election, which makes potentially politically difficult decisions all that much harder to take. As such, Republican tax-writers must follow Chairman Brady's advice and "seize the moment" or risk losing the opportunity to deliver "a better way" for US tax policy. President Trump is scheduled to address a joint session of Congress on February 28 and it is expected that the content and timing of his tax reform proposals could become clearer during that speech or in a White House briefing to follow.

Australia Implements New Diverted Profits Tax

Louise Boyce

The Australian government has introduced legislation into Parliament to implement the new Australian Diverted Profits Tax from July 1, 2017 to both new and existing arrangements.

This legislation is being seen by the Australian government as a powerful tool to tackle contrived tax arrangements and uncooperative taxpayers by imposing a penalty tax rate of 40% on profits diverted to offshore-related parties (where the normal corporate tax rate in Australia is 30%). The provisions will apply where a significant global entity enters into an arrangement with a related entity for the purpose of obtaining a tax benefit or reducing a foreign tax liability. There are some exceptions, such as where the turnover in Australia would be less than AUD$25 million, if the arrangement has sufficient economic substance, or if the foreign tax is 80% or more of the tax that would have been paid in Australia (effectively if the offshore tax rate is 24% or more). The Australian government considers that this legislation will result in Australia having some of the toughest laws in the world to combat multinational tax avoidance.

In a related change, the penalty for failure to lodge documents on time for significant global entities has been increased 100 times, with a potential maximum penalty of AUD$525,000 for failure to lodge documents (including income tax returns, activity statements and Country-by-Country reporting). The massive increase in these penalties is as a result of the concern that the previous penalties did not act as sufficient deterrent for non-compliance by significant global entities.

While Australia already has strict transfer pricing, multinational anti-avoidance and general anti-avoidance regimes, this legislation is seen as being another method by which the Australian Taxation Office (ATO) can force significant global entities to comply with their tax obligations and pay what the ATO regards as the appropriate amount of tax in Australia. There are approximately 1,600 significant global entities with operations in Australia that could potentially be impacted by these new provisions.

EU Corporate Tax Reform

Wolfgang Maschek and Christine Economides

Following the Panama Papers revelations, the European Commission proposed a number of legislative initiatives in an effort to close the related "loopholes" in the European Union (EU) tax framework. The initial package of legislation focused on anti-tax avoidance measures was adopted in only five months – a record time for EU standards. As a complementary measure to the anti-tax avoidance package, a very recent legislative proposal addresses primarily corporate tax reforms.

The proposed reform package includes:

- A proposed Common Consolidated Corporate Tax Base (CCCTB) framework, to be achieved in the following two steps:
  i. The Common Corporate Tax Base (CCTB): this first step would foresee that multinational companies in the EU will face a mandatory common corporate tax base if their consolidated group revenues exceed €750 million in the previous financial year

ii. A Common Consolidated Corporate Tax Base (CCCTB): in this second step, the profits and losses of a company across different member states would be consolidated in order to come up with a net profit/loss for the whole of its activity in the EU

- A proposed directive on a double taxation dispute resolution mechanism
- A proposal to amend the Anti-Tax Avoidance Directive to extend the rules addressing hybrid mismatches with Third Countries (a proposal that has been recently approved and will now be implemented)

There has been a lot of controversy following the publication of this package, especially regarding the CCTB/CCCTB proposals. It is worth noting that this proposal was initially put forward in 2011, but the 28 EU member states at that time did not agree with the principle of the directive. The European Commission was pushed by member states to draft a new proposal with two key changes introduced: (i) the proposal would be mandatory for multinational companies exceeding the threshold defined above, and (ii) a two-step approach would be taken where the tax base would be agreed on a common basis following the consolidation.

The EU Council (i.e., the body representing the 28 EU member states) is leading the negotiations, as is typically the case for any tax-related legislative initiatives. Unanimity is required in the EU Council in order to formally adopt any new tax measure, including the above listed CCTB/CCCTB proposals. The national parliaments of seven member states (Denmark, Ireland, Luxembourg, Malta, the Netherlands, Sweden and the UK) have recently expressed their opposition to the proposal, suggesting that the proposal breaches the EU subsidiarity principle and thus, would be harmful to national sovereignty. Their objections so far were, however, not enough to force the European Commission to re-examine the proposals. Other member states also raised concerns about the proposals, which may lead to further delay or even the abandonment of the negotiations.

Interestingly, Malta, which currently holds the rotating EU Council presidency, has strongly opposed the proposals. Typically, the country that holds the EU Council presidency remains neutral and considers all positions as an "honest broker." We do not expect the Maltese to make significant process on this file in the first half of 2017.

French BEPS Country-by-Country Reporting

Philippe De Saint-Bauzel and Stéphanie Nègre

In 2016, France introduced a new Country-by-Country reporting obligation (in accordance with the framework of the G20/OECD BEPS measures). In accordance with such obligation, French companies belonging to multinational groups may have to file a new tax return in the 12 months following the end of the fiscal year. Such return must mention, for each jurisdiction, intragroup transactions' turnover, turnover realized with third parties, total turnover, benefit or loss before tax, corporate income tax paid, share capital, undistributed profits, number of employees and tangible assets excluding cash. Information will also be required regarding activities undertaken.

In practice, such new reporting obligation applies to French entities:

- Setting up consolidated accounts
- Owning foreign branches or controling directly or indirectly one or more subsidiaries
- Realizing an annual consolidated turnover (excluding tax) of at least €750 million
- Not held by French entities or foreign entities subject to the same reporting obligation pursuant to French or foreign laws

French entities can also be subject to such reporting obligation, if they are held directly or indirectly by an entity established in a foreign state or territory that does not implement a similar reporting obligation and would have been subject to it if established in France. In this case, the French entity must comply with the reporting obligation if it has been appointed by the group to submit the report or it cannot demonstrate that another entity of the group (French or foreign) has been appointed to do so.

A list of states and territories implementing similar reporting obligations will be set up by the French government. For informational purposes, as of January 30, 2017, 57 countries have signed the multilateral agreement related to transparency and exchange of information, including Gabon, Hungary, Indonesia, Lithuania, Malta and Russia.

From a practical standpoint, the first reports will have to be filed before December 31, 2017 for fiscal year 2016, which ended on December 31, 2016.

Germany Acts to Curb Tax Effects of Patent/IP Box Regimes

Thomas Busching

Following an extremely brief public consultation, Germany has officially tabled its draft bill limiting the tax effects of royalty and license fees paid to patent boxes. The essence of the new rule is that royalties will not be tax deductible for German businesses if the effective tax rate of such royalties in the hands of the recipient falls below 25%. The lower the tax rate, the higher the non-deductible percentage will be on a sliding scale: 0% rate – royalties completely non-deductible; 5% rate – 80% non-deductible; 10% rate – 60% non-deductible; 15% rate – 40% non-deductible; and so on. Further conditions include the following:

- Royalties include all fees paid for the use of a wide range of intellectual property
- Only intra-group royalties are affected, whereby, branches are deemed to be intra-group
- Intra-group back-to-back or flow-through arrangements are also captured
- Effective date shall be January 1, 2018

In line with the "nexus approach" of the OECD's BEPS Report, however, relief from the limitation will be granted if the IP was predominantly self-developed by the recipient of the royalties. Consequently, acquired IP or IP substantially developed by another group company will not qualify for relief. In addition, licenses for the use of trademarks or trade names do not qualify for relief – whether or not developed by the recipient.

It follows that royalty payments to countries that also grant preferential tax rates for acquired – and not only for self-developed – IP will be scrutinized the most. These countries include Hungary, Luxembourg, Malta, Cyprus, Liechtenstein and the Swiss Canton of Nidwalden.

Other affected countries may be those that grant tax benefits for IP improvements, partial development, active management or coordination such as Belgium, the Netherlands or the UK.

According to Germany's own accounts, the additional tax revenue from the draft bill will total a meager €100 million for the three years 2019 to 2021. To put that into perspective, Germany's excise tax on sparkling wine rakes in four times as much in one year.

Despite the fact that OECD members and the G20 – which includes Germany – have agreed to grandfather and to abolish non-compliant IP boxes by June 30, 2021, Germany seems to be wary that not all will follow through. Germany has consequently decided to act unilaterally with this draft bill instead of putting its trust in the member countries' adherence to international agreements. While this wariness may be understandable under current circumstances, Germany should consider that there may be undesired repercussions for such premature actions. If Germany walks away from its initial undertaking to grandfather existing patent box regimes until 2021 within the BEPS framework, it may lose its authority to claim more important adherence to the BEPS agreements from other member countries – in order to gain a fraction of the revenue generated by a negligible tax as demonstrated above. In other words, in our view, there may well be more lost than gained by premature and unilateral actions such as the draft bill.

UK Modernizes Corporation Tax Relief for Carried-Forward Losses

Robert O'Hare

The current UK rules providing tax relief for a company's carried-forward losses are relatively narrow. Broadly speaking, (i) carried-forward trading losses can only be offset against later profits from the same trade, (ii) carried-forward non-trading losses can only be offset against later non-trading profits, and (iii) amounts carried-forward of any description cannot be surrendered to another company in the same group.

From April 1, 2017, the restrictive nature of the rules is being relaxed so that, very broadly, carried-forward losses can be used in a similar way to current period losses. The new loss flexibility is, however, counterbalanced by new loss restrictions.

New Loss Flexibility

Under the new provisions, subject to certain priority rules, a company will be able to claim relief for some (or all) of its unrelieved:

- Trading losses
- Non-trading losses (i.e., deficits) on loan relationships and intangible fixed assets
- Management expenses
- UK property losses

for a period by offsetting them against its total profits of the next period (or later periods). The carried-forward losses, deficits and expenses will also be available for surrender to another member of the same group under group relief.

The relaxation is further extended to the terminal losses rules so that, where a company ceases to trade, it will be able to set any used carried-forward losses against total profits arising in the last three years of the trade.

The new provisions make no change to the treatment of allowable losses under the chargeable gains legislation.

New Loss Restriction

Despite the welcome flexibility afforded by the new rules, they come with a sting in the tail: subject to an annual allowance, amounts against which carried-forward losses can be relieved are limited to just 50% of taxable profits (or, if the company happens to be a bank, just 25% in respect of pre-April 1, 2015 losses, deficits and expenses carried forward). The restriction does not, however, apply in cases involving the three-year carry-back of terminal losses.

Each company (or group) is entitled to an annual allowance that means the first £5 million of profits of the company (or group as a whole) will not be restricted. This relaxation is intended to ensure 99% of companies will not be affected by the restriction, but the effect in practice is far from clear. The broad definition of group for these purposes, for example, means the availability of the allowance can be quickly diluted. In addition, in circumstances involving companies in financial distress or undergoing formal insolvency arrangements, the new restrictions could actually hinder corporate rescues because of the limitation on relief on the "profit" arising from the forgiveness of a debt.

Where the restriction applies, the effect of the new rules is to lengthen (possibly indefinitely) the period over which a company can obtain relief for losses it incurs. It is noteworthy that one of the stated aims of the new rules is to ensure that, irrespective of their past performance, companies will always pay some tax in any period during which they make a profit.

Anti-avoidance

The proposals inevitably contain a number of anti-avoidance measures, including, in particular:

- **Loss buying rules** – In situations where a company (or group) is acquired, any carried-forward losses arising to a company before its acquisition will not be available to the purchaser's group for five years.
- **A targeted anti-avoidance rule** – Arrangements entered with a main purpose of either obtaining more loss relief than is intended or circumventing the new restrictions will be counteracted.

Commencement

The new rules are expected to be included in the Finance Bill 2017 (which will ultimately become Finance Act 2017 later in the year) and, subject to certain transitional provisions, will take effect in relation to losses arising on or after April 1, 2017.

It is important to note the effect of the commencement provisions. While losses arising before April 1, 2017 will remain subject to the existing rules (i.e., they will be ring-fenced and *will not* benefit from the greater flexibility), they *will* be subject to the greater restriction on the amount of profit against which they can be relieved.

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