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The Imperfect Storm

Views on the Impact of the 2016 US Election on US and Global Tax Reform

Executive Summary

The imperative for fundamental and comprehensive tax reform in the US (and the around the world) has reached a head at a time when a new political order seems to be emerging. Populist and nationalist political agendas sit uncomfortably in an internationalized, integrated economic reality. As new challenges abound, the need to update the existing international tax law infrastructure has taken on an even greater importance.

The OECD Base Erosion and Profit Shifting (BEPS) project has proposed a new framework for international fiscal co-operation. The success of BEPS, however, depends on how it is implemented. The steps taken by the EU to adopt and move beyond BEPS represent one response: fixing the shortcomings in the current system while, at the same time, both protecting the existing tax base and seizing an opportunity to aggressively expand it.

Maintaining balance in the global system will require engagement all around the world, and especially from the US. With control of White House, Senate and House, President-Elect Trump and the Republican Party have an opportunity to both carry through root and branch reform of the US Tax Code and reassume the US lead role on the international fiscal stage.

It seems unlikely though that President Trump will be proactive in formulating a new world fiscal order. While some form of US tax reform is almost inevitable, significant obstacles still lie in the way. The new administration is likely to have a protectionist and isolationist outlook and the US looks likely to continue to pick and choose what parts of BEPS to implement. The risk is that without the balance provided by the US, the future direction of global tax policy could be once again warped as countries turn away from multilateralism and the world reverts to unhealthy tax competition.

Background

After a long and interesting campaign race, at last we know – the 45th President of the United States and new leader of the "free world" is to be Donald John Trump. As the Lame-Duck session begins, Mr. Trump has already begun assembling the team that he has promised will "Make America Great Again". Below is an analysis of what a Trump administration potentially means for US tax reform and the role of the US in formulating the future direction of global tax law. Specifically, after examining the emergence of a new political order, this article considers the impact and importance of two macro developments on the prospects for fundamental and comprehensive tax reform in the US – the ongoing G20/OECD BEPS Project and the EU's ambitious plans for tax reform.

The Gathering Storm

It is entirely possible that history will judge the 2016 US Presidential election as evidencing the dawn of a new era in politics and as exemplifying a paradigm shift away from "politics as usual." This most recent US election is not, of course, a unique example of this disruption in the political arena. The decision of the United Kingdom to leave the European Union (the so-called Brexit), the rise in popularity of nationalist, generally Eurosceptic politics across Europe (witness, for example, Viktor Orbán in Hungary, Marine Le Pen in France, Geert Wilders in the Netherlands, and Beppe Grillo and the Five Star Movement in Italy), a Europe increasingly divided internally, and an isolationist US, all suggest that many countries are looking to put up walls in order to "protect" their economies and people.

This global political disruption will likely have significant ramifications when it comes to tax law, policy and the future prospects for reform in the US and around the world. The *economic* reality is that the world grows ever smaller as free trade continues to spread, markets integrate, developing countries continue to develop, new markets emerge, existing markets evolve and become more complex, and all the while a digital revolution turbocharges the process. Economic globalization necessitates global co-operation so that fiscal policy is developed to reflect the expanding network and keep the system in balance.

Most would agree that never before has there been a greater need for global tax reform. It is well documented that the fragmented and antiquated nature of the current global tax system simply is not fit for purpose as it does not reflect the growing interdependence of nation states, the permeability of borders, and the growth of the digital and "gig" economies. Worse still, the current system is failing to ensure the benefits of a globalized economy are spread more evenly among people.

Coincidentally, in light of the political challenges faced by Western democracy, never before has there been a greater opportunity, or need, for its greatest power and economy, to take a lead in shaping, supporting and implementing the global reform that is necessary. A good place to begin demonstrating that leadership might be to achieve a comprehensive overhaul of the US Tax Code for the first time in over 30 years in a manner that both embraces the global economy and addresses its inherent inconsistencies. The question is whether President-Elect Trump will be able and willing to seize that opportunity.

G20/OECD BEPS

The process of updating the current infrastructure of international tax law has significantly advanced in the last several years. Most significantly, the G20-backed OECD BEPS package ("BEPS package") is intended to be a comprehensive package of measures to tackle abusive tax planning by some multinational enterprises (MNEs). According to the OECD, such planning exploits weaknesses and loopholes arising from the interaction of the domestic tax regimes of different countries. The lack of coordination and information sharing among national fiscal authorities exacerbates the situation and arguably allows MNEs to engage in inappropriate tax planning.

As a result, the BEPS package is built along three guiding principles – (i) coherence through consistent and coordinated measures, (ii) substance through aligning taxation with economic value creation, and (iii) transparency through information exchange agreements. These principles underpin the creation of a new international tax framework that is intended to fundamentally re-evaluate tax policy on a global scale. It has been an enormous undertaking and represents a major achievement of international fiscal co-operation. Published in 2015, the final BEPS package contains conclusions and recommendations that are wide-ranging and far-reaching.

The true measure of success for the BEPS initiative, however, depends on the breadth and consistency of implementation around the world. While some measures will be implemented at a supra-national level (including, for example, revisions to the OECD's Transfer Pricing Guidelines and, assuming it is endorsed, the multilateral instrument (MLI) amending tax treaties), the central core of proposals will need reform at the domestic level. These include the proposals for new rules on hybrid mismatches, controlled foreign corporation (CFC) rules, interest deductibility, country-by-country reporting (CbCR) and mandatory disclosure. The emerging post-BEPS environment presents sovereign states with a unique opportunity to recalibrate their domestic tax codes to a new global gold standard that is built upon shared foundations.

EU Tax Reform

As the OECD has no power to force implementation of its recommendations or proposals, implementation is left to individual states. With one or two very noteworthy exceptions (including, to date, the UK), most countries are currently delaying implementation while they assess what others are going to do. Some are in the process of adopting minimal changes in order to appear to be compliant while at the same time not jeopardizing their competitive advantage.

This minimalist approach, however, is not the strategy of the EU. If the G20/OECD BEPS project represents the *theoretical* basis for international tax reform, the EU's response represents the most exuberant example of its practical *implementation* – it has, in the words of Pierre Moscovici (European Commissioner for Economic and Financial Affairs, Taxation and Customs) seizing on one of the central themes that underpin BEPS, "launched a tax transparency revolution". The EU has indicated it is unwilling to accept the risk that its Member States will implement the BEPS Package "in divergent ways or have varying interpretations of the OECD BEPS measures".

The result is that the EU has ventured further than ever before into a realm that is traditionally the sole reserve of sovereign states. In turn, this has led to the evolution of a bold, new, dual approach to tax reform for Europe. First, the EU has *followed* BEPS very closely as a way of addressing the causes of abusive tax-avoidance within the EU. Second, and far more significantly, the EU has *moved beyond* BEPS by taking the opportunity to reformulate the corporate tax framework of the EU through the re-launch of its Common Consolidated Corporate Tax Base (CCCTB) proposal, as well as its aggressive use of State Aid regulation to lay claim to 'stateless profits'.

The BEPS-related dimension of the EU's approach is set out in its Anti-Tax Avoidance Package and is made up of several parts, including:

- The Anti-Tax Avoidance Directive (ATAD) – the ATAD will be legally binding on all Member States, which will need to implement it with effect from 1 January 2019, and includes provisions (based on BEPS recommendations) addressing:
  - Hybrid mismatches (within the EU and, as part of the EU's Corporate Tax Reform package, externally)
  - Restricted deductions for interest
  - A general anti-abuse rule (GAAR) to counteract aggressive tax planning when other rules do not apply
- A recommendation on Tax Treaties – the recommendation sets out how Member States should implement the BEPS proposals affecting their double tax treaties "in an EU compliant way" including, for example, the introduction of a treaty-based GAAR based on a "principal purpose test" (PPT).
- A revision to the Administrative Cooperation Directive (DAC)— the revised DAC introduces CbCR between tax authorities. A proposal, going well beyond BEPS, also exists to require MNEs to make CbCR information public.

It is, however, the re-launch of the EU's CCCTB proposal (as part of a new Corporate Tax Reform Package) that illustrates the narrow focus of the BEPS project to fix the current system. The CCCTB, for all its faults and imperfections, illuminates a possible path beyond BEPS that could see a more fundamental change in the global system. Mandatory for all groups with global consolidated revenues of more than €750 million, the CCCTB sets out a Europe-wide system for the calculation of taxable profits. It is a super-charged BEPS that redraws the boundaries of the taxable base across an entire continent.

While a CCCTB would undoubtedly restrict avoidance opportunities within Europe and would probably reduce the compliance burden and costs for companies operating in the EU, the more innovative, perhaps even revolutionary, aspects of the proposal include:

- New R&D Europe-wide incentives, recognizing the changing nature of the global economy and encouraging innovation and growth
- An "Allowance for Growth and Investment" (AGI) investment (i.e., a deduction for equity capital) to redress the *"current debt-bias in taxation, which allows companies to deduct the interest they pay on their debts but not the costs of equity"*

- A formulary apportionment method for the sharing of taxable profits between Member States, openly rejecting the use of more traditional transfer pricing methods championed, and preserved under BEPS, by the OECD

Although the actual implementation of the EU's wider plan in its current format is far from certain, it has been promoted aggressively by the European Commission as benefitting civil society, citizens and business. At a basic level, it could be seen as a genuine attempt to ensure that tax policy plays a part in redistributing the benefits of the globalized economy more widely and fairly.

Blame for any failure to adopt this new plan, and the inevitable consequential allegations of failing to crack down on tax avoidance and make companies pay their fair share, will then be laid squarely at the door of any recalcitrant Member State – and provide more fuel for the fire that globalization has failed and the establishment remains rotten. The political will and determination in the European Commission to push the wider Tax Reform Package through is undeniably palpable. Perhaps even more importantly, however, the EU's Anti-Tax Avoidance and Corporate Tax Reform Packages represent a holistic response to the BEPS package that not only adopts the OECD's proposals without exception, but also seizes the moment to incorporate measures that are clearly designed, alongside a broad use of State Aid, to protect (and perhaps even expand) the EU's economic interests in the global economy.

US Tax Reform

In the context of this global push for tax reform, it has now been over 30 years since the US Tax Code was last overhauled (during the Reagan administration). Both Democrats and Republicans have long recognized and accepted the pressing need to reboot their domestic tax system and "fix the broken Tax Code." Both sides have, in recent years, also formulated various programs for what tax reform might look like. The debate has not been about whether the Tax Code should be reformed, but rather about what changes to make and how to pay for such changes. The main obstacle in the way recently has been a divided administration with a Democrat President and Republican Congress blocking each other proposals – legislative gridlock with only minor changes being made around the edges in the form of Internal Revenue Service Notices and Treasury Regulations.

In a somewhat unexpected turn of events, the gridlock may be lessening now that Mr. Trump has taken the White House and the Republicans have managed to maintain control of the Senate (albeit with a very slim majority) and continue to control the House of Representatives. Furthermore, there are significant indicators that point toward the necessity for reform, including the *opportunity* presented by the recent EU actions and the OECD BEPS project and the *risk* that the US will be left behind and isolated by BEPS-compliant developments around the globe if they fail to take steps to remain competitive.

The high US corporate tax rate (35% federal rate), coupled with a relatively narrow base and a worldwide tax system that actually encourages companies to keep profits overseas indefinitely, is what many argue makes the US uncompetitive in today's market. A fiscal policy that has been unable to adapt to a changing global economy is cited as the major cause of the swath of corporate inversions that have troubled the US in recent years.

Ironically, had the US found a way to carry out tax reform earlier and reduce its headline rate to something lower, it may have restricted the arbitrage incentive for the type of complex structuring undertaken by many companies over the past several decades. It is even conceivable that the BEPS project itself may not have been initiated.

It is possible, however, that the sheer unattractiveness of the current US tax regime, coupled with the vast amount of funds sitting overseas and the equally vast deferred tax liability that attaches to any repatriation of those profits, could actually mean US businesses are more willing than ever to engage with a process that might lead to genuine and certain reform. One significant consideration, however, is that the tax hit incurred by repatriating such vast sums could be so enormous (no matter how low the imposed rate might be) that US corporations will not be willing or able to absorb the potentially negative financial statement impact. If that latter scenario is right, the ability to tax the profits sitting offshore may be forever lost to the US.

It is interesting to note that the final BEPS package has a distinctly US feel to some of the provisions, such as the proposals for CFC rules and the inclusion of a limitation of benefits (LOB) clause in double tax treaties. Also interesting is that the entire movement toward tax transparency and the automatic exchange of tax information across borders – the most crucial concept at the heart of BEPS and the changing tax landscape – can be aligned with a US idea, FATCA. Although the US has intentionally kept a low profile in pushing the BEPS project forward and been resistant to adopt many provisions of the BEPS package, its influence behind the scenes is unmistakable. The US now needs to find a path forward that is co-operative with global tax reform. This is important if it wishes to have a seat at the table and influence the implementation process while at the same time only implementing those provisions that will not be disadvantageous for US companies.

Could it be that, boosted by a renewed commitment to tax reform at home, the time has finally come for the US to emerge back into the open and reassume a lead role on the international fiscal stage, facilitating and concluding multilateral negotiations in the best interests of economic development and co-operation? If nothing else, if the US were to do so under the leadership of its new, business-oriented President, it might just help restore a degree of equilibrium and balance to the global fiscal order by dampening down the more exuberant or overly ambitious moves of others.

The Imperfect Storm

Although there seems to be a perfect storm brewing to finally achieve meaningful US tax reform, there are two significant hurdles to overcome - the new President and the US political system.

Although the possibility for US tax reform is more likely now than if Hilary Clinton had won the presidential election, it will not necessarily be the "right" kind of reform that will benefit the global economy. President-Elect Trump has campaigned on a platform of protectionism, isolationism, and an 'America first' outlook. His rhetoric has centered on building walls, ripping up free-trade agreements, imposing tariffs and duties on goods entering the US. To date, he has shown little appreciation of the intricacies of established international politics. Indeed, he was elected *because* he was not the establishment. President-Elect Trump has also yet to show much enthusiasm to engage with the world politically or economically.

Extrapolating Mr. Trump's campaign platform into tax policy, it is almost inconceivable that he will advocate for a realignment of the US tax system that is consistent with the BEPS package or be willing to take a more proactive and leading role in formulating and overseeing the creation of a new world fiscal order.

So what is likely? The GOP, under the leadership of Chairman of the House Ways and Means Committee, Rep. Kevin Brady (R-TX), has already developed a significant "blueprint" (a Better Way) for tax reform that covers all of the modern bases: a broader tax base, a dramatically reduced corporate rate, a move towards a destination-based approach to tax, and a territorial system together with a very low one-off rate for profits repatriated (if any). Much of the Blueprint actually accords with the pronouncements on tax made by President-Elect Trump on the campaign trail as part of his massive, largely unfunded, suite of incentives designed to boost growth in the US economy. The irony is that most of the tax proposals put forward by the anti-establishment President-Elect, elevated to the White House on the back of votes from the many "left behind," will primarily benefit the "few" as they generally reinforce the socio-economic status-quo in the US.

It is noteworthy that very quickly after the election was called for Trump Chairman Brady was giving interviews to the major TV networks promoting the Blueprint and claiming he was ready to carry US reform through and slating it as an issue to be addressed in the new President's first 100 days. It is also significant that Paul Ryan (R-WI), a former tax writer, appears to have returned to the GOP fold and will remain as Speaker of the House where he will be able to oversee and smooth the passage of any bill for reform. Since it is extremely difficult to see the new President getting down and dirty with the detail of tax reform, the Blueprint, undoubtedly the GOP's opening position in any negotiations, now looks (with the addition of a bit more detail) like forming the most credible basis for a comprehensive program for US domestic reform; so long as he doesn't stray too far, Trump is likely to let Brady initiate the discussions on this basis.

Although the Republicans have control of all three pillars of power in Washington, their control of the Senate is tenuous. This is because the minority Democrats can still engage in a filibuster - the ability of one or more senators to prevent a measure from being brought to a vote. Republicans could only stop a filibuster if they had at least 60 votes, which they currently do not have. The engagement of the Democrats is, therefore, probably necessary to at least oil the wheels that have started to roll. Democratic thinking around tax reform lies with prominent figures such as Sen. Charles Schumer (D-NY) – who has considered a deemed repatriation of overseas profits to be charged at a reduced rate – and Sen. Ron Wyden (D-OR). Schumer's plans, however, have already met with opposition from within the Democratic Party, while Wyden's thinking has been so narrowly focused (primarily on the treatment of depreciation expenses) as to be almost irrelevant at the international level. And, given the election of a Republican President, the Democrats (including, in particular, rising star Elizabeth Warren (D-MA), allied with independent activist Sen. Bernie Sanders (I-VT)) are unlikely to make things too easy. Even there, though, the argument is colloquial, domestic, and narrowly focused on the best interests of the US alone. Furthermore, the bipartisan agreement on the need for investment in infrastructure might just be enough to overcome most obstacles to reform.

Problems exist when it comes to engagement with BEPS and the wider fiscal community from the US Treasury too. The silence from the US in terms of BEPS implementation generally has been deafening. Compared with the EU (including the UK), US plans to adopt the recommendations in the BEPS package are almost non-existent. There is quite clearly an ongoing calculation on whether BEPS will benefit the US or not and, therefore, picking and choosing what, how and when to implement it in the US. The installation of a protectionist, populist, anti-establishment, anti-trade President is unlikely to herald a change in direction inside the US Treasury. President Trump will not want, and (assuming some version of the Blueprint is pushed through Congress in the course of 2017) he may feel he does not need, to engage with BEPS discussions.

This sense of inward-looking focus in the US, while not fatal to its continuation, may be a problem for the BEPS project which, without the active buy-in of the major player in the game, would inevitably fall well short of its lofty aims. At the same time, failure to engage could equally harm the US in the longer term if it is left outside a new global fiscal order with a tax system that is based on inconsistent and isolationist principles which, at the very least, present the opportunity for continued erosion of the US tax base and for companies to shift their profits outside of the US tax net.

Conclusion

The rise in populist and nationalist political agendas is not well aligned with an internationalized, integrated economic reality. What has made the US great historically has been the strength and leadership it has shown the world while being mindful of the power this influential role holds. It remains to be seen where US tax reform will head in the coming years, but the world will be anxiously watching and waiting to see where the US is headed under a Trump presidency.

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