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Indice

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U.S. Tax Policy and cross-border investments in 2019: the general picture*

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* This article is based on the presentation made by the Author at the Meeting *La competizione fiscale tra Stati con particolare riguardo al rapporto tra Unione Europea e USA*, held in Rome, Sapienza University on 23 February 2019.

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Abstract

La nuova legge fiscale statunitense, denominata Tax Cuts and Jobs Act *(TCJA) - approvata il 22 dicembre 2017 - ha generato nel Paese un consistente flusso di critiche. Alcuni commenti provengono dalle stesse Autorità fiscali statunitensi, che hanno dovuto elaborare migliaia di pagine di disposizioni attuative che non hanno agevolato l'interpretazione delle nuove norme. Inoltre, sono stati pubblicati numerosi articoli che analizzano la nuova legge ed esprimono giudizi negativi sul suo significato e sulla sua concreta efficacia.*

Secondo l'Autore, come in ogni altro atto legislativo statunitense «il diavolo risiede nei dettagli» e tali dettagli sono stati sviscerati dai consulenti fiscali con interesse e, tal volta, anche entusiasmo. Questo articolo, tuttavia, tralascia volutamente gli aspetti tecnici, così come i giudizi sull'opportunità della nuova legge e nemmeno si sofferma sugli aspetti domestici della TCJA, sebbene questi temi meritino di per sé una approfondita riflessione. Per di più, l'Autore non si occupa della tassazione a livello statale che, peraltro, ha assunto importanza relativa a causa della riduzione del carico fiscale federale disposta dalla stessa TCJA. Il presente articolo si pone, invece, l'obiettivo di analizzare le disposizioni federali aventi specifica rilevanza transnazionale al fine di valutarne l'impatto negli Stati Uniti e in tutto il resto del mondo.

L'Autore conclude le sue riflessioni con una nota di pessimismo, affermando che, nel deliberare la riforma fiscale in commento, il Congresso non ha consi-

derato che le opportunità di crescita per gli investitori statunitensi si collocano principalmente all'estero. Pertanto, nonostante le potenzialità insite nella TCJA - alla quale non può essere negato il merito di aver apportato una svolta nell'architettura della tassazione internazionale - nessuna nuova regola avrà mai la forza di sovvertire la struttura economica degli Stati Uniti incentivando l'aumento degli investimenti.

1. Brief introduction

The new (and still in the process of being digested) U.S. tax legislation, the Tax Cuts and Jobs Act (TCJA), was enacted on December 22, 2017 and has engendered a steady stream of commentary - critiques, explanations, interpretations - ever since. Some have come from U.S. tax authorities in the form of thousands of pages of proposed and some final regulations. In addition to the many formal comments on the proposed regulations, there have been numerous articles analyzing the new law and expressing judgments about its meaning and effectiveness.

As with any piece of U.S. tax legislation, the devil lies in the details, and tax advisors throughout the United States have been poring over those details with interest and enthusiasm. This article, however, will skirt the technical points, as well as judgments about the wisdom of the new law. The TCJA provisions are clearly with us to stay for several years, at the least, so judgments can safely be withheld for the time being.

Moreover, this article will spend no time on domestic aspects of the TCJA, although there is plenty to reflect on there. It will not deal at all with taxation at the state level, which is found in most of the fifty states and has assumed greater relative importance now, given the TCJA's reduction of the federal tax burden. The article will concentrate on those federal provisions having cross-border relevance. And it will come to the topic from a high perch. The goal is to explain what cross-border aspects of this important new statute mean, in relatively accessible terms, for the United States and for the rest of the world.

2. Background on the TCJA

U.S. tax law has long been complicated. But U.S. international tax policy, though expressed in intricate rules, has not heretofore been hard to grasp. Prior to the TCJA the United States was a high-tax country insofar as the income tax is concerned, with a corporate rate of 35 percent and a top individual rate of 39.6 percent. At the individual level there was and still is a separate net investment income tax of 3.8 percent, an additional Medicare tax of .9%, and a limitation on the deductions of high-income taxpayers. For both individuals and entities income is fully taxed on a worldwide basis, but the separateness of corporations from both shareholders and other, related corporations has always been respected. Non-U.S. persons making inbound investments in the United States have encountered specific limitations on their interest deductions and the U.S. tax treaty network has become increasingly hostile to treaty shopping. Transfer pricing principles are administered pursuant to detailed and sophisticated rules, and applicable to everyone - not just inbound and outbound transactions but to purely domestic transactions as well.

The United States has no value added tax or similar levy at the federal level, and for a variety of reasons that is not likely to change. Many states have their own income taxes, imposed at rates up to 12 percent, and most depend on some form of sales tax.

Income produced by outbound investments of U.S. persons is fully subject to income tax. The income of foreign corporate affiliates, however, has generally not been subject to current U.S. tax, and there are two separate anti-abuse regimes, subpart F and PFIC, designed to limit the benefits of «deferral» of U.S. tax with respect to certain kinds of income. The anti-abuse rules have come under stress in recent years as taxpayers have devised ways to game the system and, more broadly, as business practices have changed.

Prior to the TCJA most active income of foreign affiliates of U.S. shareholders was thus effectively exempt from U.S. taxation and would become subject to taxation only when the shareholder chose to repatriate the income to the United States. U.S. multi-national companies were permitted by the financial accounting profession to report affiliates' earnings with no «tax effect» for the eventual U.S. tax, on the theory that repatriation was strictly elective and «investment» abroad could benefit from «deferral» for a very long time.

The incentives at play for cross-border investments were clear. An inbound investor would seek to avoid the U.S. tax system altogether, with its relatively high overall U.S. tax rates (and serious reporting and compliance burdens) and would seek to reduce its U.S. tax base, to the extent it could not avoid having a U.S. tax base, by deducting cross-border expenses such as interest, royalties, management fees, and the like, transferring monies to low-tax jurisdictions if possible.

The outbound investor, on the other hand, would place as much income as possible in foreign corporate solution and take advantage of «deferral» indefinitely. As in the case of the inbound investor, the aim was to avoid the U.S. tax net. This, of course, required steering clear of the U.S. anti-abuse rules.

Both types of investors had to contend not only with U.S. taxation, but with business exigencies and taxes imposed by other countries. They were not necessarily free to pursue the most straightforward path to escape the U.S. tax system. There have been many variables on the general theme of the incentive to avoid that system.

3. The new rules

The TCJA upended the calculus described above for the simple reason that it was intended to do precisely that. The principal aim was to attract investment to the United States, and thus to the very U.S. tax system that was to be avoided at all costs under pre-existing rules. A secondary goal was to impede taxpayer efforts to avoid all tax by transferring income-producing assets, particularly intangible assets, into foreign affiliates located in low-tax or zero-tax jurisdictions. The new law has not (yet) worked exactly as envisioned, and there is some suggestion that prior incentives may come roaring back. But it is too early to reach any conclusion about that.

The new corporate rate established by the TCJA is 21 percent, a 40 percent reduction of the prior rate. And the new statute is all about corporations. Individuals are barely an afterthought in most of the newly enacted cross-border provisions, and they receive few of the benefits studded throughout those provisions. Though the maximum rate of tax for individuals has been reduced by the TCJA to 37 percent and the prior rules limiting deductions of high-income individual taxpayers have been eliminated, the new international rules mostly deal with corporate matters.

In addition to reducing the corporate rate, the TCJA provided for depreciable investments to be expensed - that is, for the entire cost to be deducted immediately upon acquisition - but only for investments within the United States and only until 2023. When coupled with the rate reduction, this constitutes a powerful attraction to lure investment into, or back into, the United States.

On the other hand, outbound investors have been called upon to pay tax immediately, albeit in eight installments and at a reduced rate, on the income they accumulated in foreign affiliates, and with respect to which U.S. tax was deferred, since 1986. It is not necessary to bring the income home to the United States but for tax purposes repatriation has been conclusively deemed to occur. This marked a «fresh start» in the taxation of outbound investment.

Going forward, there is a minimum tax imposed on most foreign income of foreign affiliates of U.S. shareholders, at approximately half the normal 21 percent rate. There are some specific exemptions, which allow for avoidance of all U.S. tax, both when income is earned by such affiliates and when it is repatriated.

The new minimum tax rule takes a dichotomous view of the world, dividing it into the United States on the one hand and everywhere else, lumped together, on the other. The tax applies to the net income of all controlled foreign corporations combined. This is an unprecedented concept.

There is also a new alternative tax, at a low rate, on a tax base computed without deductions for interest, royalties, and other amounts paid to related foreign persons, and with no foreign tax credit allowed. This alternative tax applies to the extent that it yields a higher amount than the normal corporate tax, with all deductions allowed. Although the form of this tax is familiar in the United States, the specific content of the new «base erosion and anti-abuse tax» and the denial of any foreign tax credit are new and unusual, and the effect of the BEAT will be highly dependent on the particular circumstances of individual taxpayers.

A preferential rate will apply to sales by U.S. corporations of property and services for foreign use. This has been described as a necessary counterweight to the minimum tax on foreign affiliate income. A preferential rate for investment within the United States is thought to discourage investors from investing through affiliates outside the United States in order to benefit from the preferential rate inherent in the minimum tax.

In both cases - the minimum tax on foreign income and the preferential rate on certain U.S. corporate sales of property and services - the rules are couched in terms of «intangible income». This term is defined as a residual - all income (with specific exceptions) that is not income from tangible depreciable property, identified conclusively as a 10 percent return on such property. In the case of foreign affiliates, that 10 percent can be earned free of the minimum tax and repatriated to the United States with no tax then. In the case of U.S. corporations making foreign sales of goods and services, the 10 percent return on tangible property is taxed at the normal corporate rate of 21 percent and does not benefit from the preferential rate. In other words, tangible property abroad is a boon for taxpayers, whereas tangible property in the United States is a burden. Given the purpose of the TCJA's international provisions, this creates a perplexing set of incentives for investment in tangible property.

In addition to the provisions just summarized, the TCJA contains significant BEPS-inspired provisions, including a strict limitation on the interest deduction for all taxpayers (not just inbound investors) and complex anti-hybrid rules extending well beyond the BEPS recommendations.

The statute validates the litigating position of U.S. tax authorities in regard to the transfer pricing consequences of an expatriation of intangible property pursuant to a cost sharing agreement. This was by far the most contentious transfer pricing issue in the United States prior to enactment of the TCJA, and U.S. tax authorities had not fared well in litigation. The TCJA effectively approves a transfer pricing methodology that U.S. courts had questioned.

The statute was drafted in haste and, as the saying goes, we can now repent at leisure. The statute contains errors and discontinuities, not to mention oddities. Its cross-border provisions did not simply replace those previously in effect, but were layered on top, including on top of the anti-deferral regime of subpart F. One of the hardest tasks going forward will be to mesh the new rules with the old.

There are many new concepts and much new language in the statute. Words are sometimes defined in ways that are mysterious to the native English speaker. There is an unending number of technical issues, which the extensive regulations have sought to address in many, but not all, cases.

4. Effects

So, where are we?

First the incentive for investments by U.S. persons outside the United States has been curtailed but probably not eliminated. There is no longer any such concept as deferral, since the new statute provides for either immediate U.S. tax or no U.S. tax at all. But there is still better tax treatment outside the United States than within it. The new minimum tax on foreign income is imposed at about half the 21 percent corporate rate. It can no longer be said, however, that the income of foreign affiliates will escape U.S. taxation altogether and potentially forever.

Second, the lowered rate of corporate tax coupled with the right to expense investment immediately will have an undoubted attraction for investors. However, federal tax is not the only tax that such investors must contend with, and when state taxation is taken into account the overall tax picture reflects relatively high continuing rates of U.S. taxation. The benefits for foreign exporting will not be lost on some taxpayers but the rules are complex and difficult to model. There could well be unpleasant surprises in store for investors who do not read the fine print.

Politicians claimed the TCJA would pay for itself through increased investment in the United States, increased jobs, more activity, more tax revenue. If this is going to occur, it will not be in the short term, since there is little sign of its occurring to date.

Apart from incentives and disincentives, the new law, comes with two features that have a tendency to blunt its effectiveness.

First, the TCJA is inordinately complex and, when combined with the numerous drafting irregularities, the result may be paralysis for many potential investors. It is difficult for any particular person to be certain about how the statutory rules will apply to its particular situation.

Second, the TCJA does not seem stable. It was enacted with votes from only one of the two major U.S. political parties, and one of the houses of the U.S. bicameral legislature has now passed firmly into the hands of the opposing party. That opposing party has pronounced itself disinclined to assist in repairing the statute without substantial changes including, ominously, a raising of the corporate tax rate above 21 percent. Most observers believe the current statute, with all its flaws, cannot endure for long without amendment, so the investor who engages in substantial and perhaps costly behavioral change, such as moving plant and equipment back to the United States from abroad, does so at some peril. On the other hand, the likelihood of any new tax legislation in the United States seems remote, given the political polarization that we are experiencing.

There is also the prospect that the TCJA will prove to be a catalyst for action and reaction by foreign governments. This could take the form of retaliatory rules aimed at U.S. investors, or it could come in improved versions of TCJA provisions but operating in reverse. If either or both of these possibilities develops into reality, U.S. companies and other U.S. investors may find themselves in an uncomfortable middle position.

In sum, the TCJA effected a major change in the architecture of international taxation, and one with potential to reverberate throughout the world. The plan was to increase investment in the United States. What the U.S. Congress seems to have overlooked is that the United States is a mature economy without infinite appetite for new investment, whereas substantial growth opportunities for U.S. investors lie mostly abroad. If indeed that is an accurate summary of the current business outlook, then all the new tax rules in the world will not suffice to achieve the results widely predicted for the TCJA.

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