Tax Cuts & Jobs Act: The Road to Reform
Reform
Results of Reform

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UF Law Summer Tax Course
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30 Years in the Making

• The last time the United States had a major tax reform was in 1986
• The Tax Reform Act of 1986
  • Ronald Reagan was president
  • The Soviet Union still existed
  • The internet didn’t exist
  • Cellphones had not been invented
  • U.S. companies occupied most of the places in Fortune top 500 list
• After the 1986 tax act, the U.S. corporate tax rate (mostly unchanged for 30 years at 35%) was among the lowest in the developed world
The Big Picture: Global Economic Trends & Int’l Tax Policy
A Changing Economy

The Largest Firms by Sector, 1967 (Market Value in $ Billions)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil &amp; Gas</td>
<td>55</td>
</tr>
<tr>
<td>Tech</td>
<td>37</td>
</tr>
<tr>
<td>Telecom</td>
<td>34</td>
</tr>
<tr>
<td>Film</td>
<td>32</td>
</tr>
<tr>
<td>Autos</td>
<td>30</td>
</tr>
<tr>
<td>Conglomerate</td>
<td>17</td>
</tr>
<tr>
<td>Chemicals</td>
<td>13</td>
</tr>
<tr>
<td>Retail</td>
<td>9</td>
</tr>
<tr>
<td>Medical</td>
<td>8</td>
</tr>
</tbody>
</table>

Industries not shown made up 2% or less of total market value among the top 50 companies.

# Fortune 500: Changing Profits

## 1985 Full list

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>Revenue  ($ millions)</th>
<th>Profits  ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exxon Mobil</td>
<td>90,854.0</td>
<td>5,528.0</td>
</tr>
<tr>
<td>2</td>
<td>General Motors</td>
<td>83,889.9</td>
<td>4,516.5</td>
</tr>
<tr>
<td>3</td>
<td>Mobil</td>
<td>56,047.0</td>
<td>2,268.0</td>
</tr>
<tr>
<td>4</td>
<td>Ford Motor</td>
<td>52,366.4</td>
<td>2,906.8</td>
</tr>
<tr>
<td>5</td>
<td>Texaco</td>
<td>47,334.0</td>
<td>306.0</td>
</tr>
<tr>
<td>6</td>
<td>IBM Business Machines</td>
<td>46,037.0</td>
<td>6,682.0</td>
</tr>
<tr>
<td>7</td>
<td>DuPont</td>
<td>36,915.0</td>
<td>1,431.0</td>
</tr>
<tr>
<td>8</td>
<td>AT&amp;T</td>
<td>33,187.5</td>
<td>1,369.9</td>
</tr>
<tr>
<td>9</td>
<td>General Electric</td>
<td>27,047.0</td>
<td>2,820.0</td>
</tr>
<tr>
<td>10</td>
<td>Amoco</td>
<td>26,049.0</td>
<td>2,183.0</td>
</tr>
<tr>
<td>11</td>
<td>ChevronTexaco</td>
<td>26,798.0</td>
<td>1,534.0</td>
</tr>
<tr>
<td>12</td>
<td>Atlantic Richfield</td>
<td>24,886.0</td>
<td>567.0</td>
</tr>
<tr>
<td>13</td>
<td>Shell Oil</td>
<td>20,701.0</td>
<td>1,772.0</td>
</tr>
<tr>
<td>14</td>
<td>Chrysler</td>
<td>19,572.7</td>
<td>2,380.0</td>
</tr>
<tr>
<td>15</td>
<td>Marathon Oil</td>
<td>18,274.0</td>
<td>493.0</td>
</tr>
<tr>
<td>16</td>
<td>United Technologies</td>
<td>16,318.0</td>
<td>645.0</td>
</tr>
<tr>
<td>17</td>
<td>ConocoPhillips</td>
<td>15,537.0</td>
<td>810.0</td>
</tr>
<tr>
<td>18</td>
<td>Occidental Petroleum</td>
<td>15,373.0</td>
<td>568.7</td>
</tr>
<tr>
<td>19</td>
<td>Tenneco Automotive</td>
<td>14,779.0</td>
<td>631.0</td>
</tr>
<tr>
<td>20</td>
<td>Sunoco</td>
<td>14,466.0</td>
<td>538.0</td>
</tr>
<tr>
<td>21</td>
<td>ITT Industries</td>
<td>14,001.0</td>
<td>449.0</td>
</tr>
<tr>
<td>22</td>
<td>Proctor &amp; Gamble</td>
<td>12,946.0</td>
<td>890.0</td>
</tr>
<tr>
<td>23</td>
<td>Nabisco Group Holdings</td>
<td>11,902.0</td>
<td>1,210.0</td>
</tr>
</tbody>
</table>

## 2007 FORTUNE 500

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Wal-Mart Stores</td>
</tr>
<tr>
<td>2</td>
<td>Exxon Mobil</td>
</tr>
<tr>
<td>3</td>
<td>General Motors</td>
</tr>
</tbody>
</table>

## 2007 Global 500

<table>
<thead>
<tr>
<th>Rank</th>
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<tbody>
<tr>
<td>1</td>
<td>Wal-Mart Stores</td>
</tr>
<tr>
<td>2</td>
<td>Exxon Mobil</td>
</tr>
<tr>
<td>3</td>
<td>Royal Dutch Shell</td>
</tr>
</tbody>
</table>
A Changed Economy

The Largest Firms by Sector, 2017 (Market Value in $ Billions)

- **Tech**: 3,710
- **Financial Services**: 1,377
- **Medical**: 1,359
- **Conglomerate**: 878
- **Telecom**: 728
- **Oil & Gas**: 641
- **Food**: 594
- **Retail**: 420
- **Tobacco**: 306

Industries not shown made up 2% or less of total market value among the top 50 companies. Market values are as of July 31, 2017.
U.S. and Global GDP

• In 1960, U.S. GDP was equal to approx 40% of global GDP
  • U.S. GDP = $543 billion; global GDP = $1.367 trillion (based on current U.S. Dollars).

• By 1980, America’s contribution to the global economy was equal to approx 26%

• Under President Reagan, it went back up, so that by 1985 U.S. GDP = 34% of global GDP

• Currently at 22%.

• Source; https://www.forbes.com/sites/mikepatton/2016/02/29/u-s-role-in-global-economy-declines-nearly-50/#70e869095e9e
US GDP as share of Global GDP
The World has Changed since 1986

- Reagan : Trump
- Shifting global power structures: West : East
- Value creation: cars : phones
- Global trade growth
- Fortune 500: U.S. : Asia
- Other countries’ corporate tax systems:
  - Lowering of corporate tax rates
  - Destination based VATs
Table 1. Percentage of Revenues/Earnings Derived From
Outside the United States

<table>
<thead>
<tr>
<th>Company</th>
<th>2003</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>E.I. du Pont Nemours and Co.</td>
<td>55%</td>
<td>60%</td>
</tr>
<tr>
<td>Exxon Mobil Corp.</td>
<td>71%</td>
<td>73%</td>
</tr>
<tr>
<td>Goldman Sachs Group Inc.</td>
<td>37%</td>
<td>42%</td>
</tr>
<tr>
<td>International Business Machines Corp.</td>
<td>58%</td>
<td>65%</td>
</tr>
<tr>
<td>Microsoft Corp.</td>
<td>34%</td>
<td>74%</td>
</tr>
<tr>
<td>Omnicom Group Inc.</td>
<td>37%</td>
<td>62%</td>
</tr>
<tr>
<td>Pfizer Inc.</td>
<td>41%</td>
<td>61%</td>
</tr>
<tr>
<td>Procter &amp; Gamble Co.</td>
<td>35%</td>
<td>43%</td>
</tr>
<tr>
<td>Ralph Lauren Corp.</td>
<td>24%</td>
<td>35%</td>
</tr>
<tr>
<td>Wal-Mart Stores Inc.</td>
<td>15%</td>
<td>21%</td>
</tr>
</tbody>
</table>
Corporate Tax Rate Changes

• The 1986 tax act lowered the top federal corporate tax rate from 46 percent to 34 percent
• In 1993 the federal corporate tax rate was increased to 35 percent
• It stayed there through 2017
Corporate Tax Rates

Figure 1.—US and average non-US OECD combined (national and subnational) statutory corporate tax rates, 1981-2018

100-Year Old International Tax System
100-Year Old Principles

• Four principles have been a part of US international tax system since its inception in the early 20th century:
  • Worldwide Taxation
  • Deferral of earnings generated by a foreign corporation regardless of whether owned by a U.S. person
  • Dollar-for-dollar foreign tax credit for foreign taxes paid
  • Separate Entity Taxation

• The new tax law (the Tax Cuts & Jobs Act) calls each of these principles into question
Worldwide v. Territorial

• The U.S. has always had a worldwide system of taxation
• U.S. persons are taxed on all of their income, wherever earned
• Most other countries have moved to a territorial system with participation exemption
• The TCJA in theory moved the U.S. from worldwide system to territorial system
Deferral
Deferral & Its Consequences

• General principle: income earned by a foreign corporation is not immediately taxed to its resident shareholder

• Almost all jurisdictions adhere to this principle

• U.S. has limited deferral since 1962 in certain cases viewed as abusive & facilitating the ability to shift income overseas
  • Or maybe even from one foreign jurisdiction to another

• U.S.: Subpart F rules

• Many other jurisdictions: CFC rules
Subpart F Rules

• Designed to capture mobile income, easily transferred
  • Passive income: dividends, royalties, rents
  • Sales income easily shifted: foreign base company sales income
  • Services income easily shifted: foreign base company services income
  • Some Insurance income
  • Some oil & gas income

• Rules based on “character” of income

• High-tax exception
  • Based on percentage of U.S. tax rate
  • Not so helpful when U.S. rate much higher than global average
Subpart F Rules Eviscerated

• 1997: Check-the-box regulations
• Designed for domestic context: taxpayers (and advisors) spending lots of time trying to figure out whether entities were taxable as partnerships or corporations for U.S. tax purposes
  • Growth of the limited liability company
• But when applied in foreign context, CTB rules meant that subpart F rules could be easily avoided
Deferral, Multiplied

• Accounting rules matter
  • U.S. accounting rules (APB23): as long as company could certify that there was no intention to repatriate earnings, no requirement to account for future U.S. tax liability on repatriated earnings
  • Created large incentive to keep earnings offshore to avoid financial statement impact of U.S. repat tax

• Legal system that permitted deferral +
  • CTB rules allowing subpart F to be avoided +
  • Escaping financial statement impact =
  • **Approx $3 trillion of earnings of CFCs held offshore by 2017**
Global Developments in CFC Rules

• EU: UK *Cadbury Schweppes* case
• UK: rethinks purpose of its CFC rules
  • Just about protecting UK base, don’t care about other countries’ tax bases
• BEPS developments
  • US pushed for tighter CFC rules as best solution to BEPS
  • Most other countries not interested
Foreign Tax Credit
The Foreign Tax Credit

• Fundamental principle of U.S. tax system
• Viewed as necessary to avoid double taxation concerns
• Enacted at a time when U.S. investment overseas was viewed as priority
  • Post-WWI
• Always 100% credit
The Foreign Tax Credit: The Last Tax Shelter?

• Congress and the U.S. Treasury have spent much effort over the past 100 years trying to limit ability of U.S. taxpayers to use foreign tax credit to offset U.S. tax liability on “U.S. source income”

• Foreign tax credit limitation
  • Limited to “foreign source” income
  • Further limited by “basket” of income
  • 7 baskets down to 2 baskets
  • Now back up to 4 baskets

• At various times, “per-country” limitation
Separate Entities

• All tax systems respect the separate existence of corporations as basis for accounting = tax calculations

• All also respect separate existence for purposes of respecting transactions between entities
70 Years of International Tax Planning
1960s-1970s: Deferral Planning

- Goals: Minimize worldwide effective tax at rate substantially below U.S. rate by:
  - Maximizing "deferral" of U.S. tax
  - Minimizing foreign tax

- Techniques:
  - Sell products through “foreign base companies" organized in low-tax jurisdictions (e.g., Switzerland, Panama, Hong Kong)
  - Base company performs marketing services and sells directly to countries without local affiliates
    - Result: shift income from countries of manufacture and sale to base company country
  - Finance high-tax subsidiaries with debt from low-tax affiliates
    - Result: reduce foreign tax without increasing U.S. tax.
    - Low tax subsidiary often located in Netherlands Antilles (treaty network)
  - Contribute technology and marketing intangibles to low-taxed foreign affiliates
    - Result: reduce U.S. and foreign tax
1960s and 1970s Planning: Techniques

- **Techniques**
  - Pay dividends out of operating affiliates as necessary or helpful to Foreign Holding Company
  - Pay dividend to U.S. parent only to the extent necessary and out of high-taxed earnings
  - Foreign Holding Company can use its funds to finance other international operations or lend excess funds back to U.S. affiliates
    - Result: can move funds to wherever needed outside of U.S. without incurring U.S. tax.
  - Lend excess cash back to U.S. parent for use in its business
  - If have foreign company (first tier) with only cash earnings, sell stock of the company and obtain capital gain treatment

- **Overall Result**
  - Minimize foreign tax by shifting income to low-tax jurisdictions
  - Minimize U.S. tax by maximizing deferral and repatriating only high-taxed subsidiary income
  - Result: potentially, an effective tax rate on all non-U.S. earnings of 10-20 percent.
Government Responses

• Before the 1986 Act, few restrictions on taxpayers’ ability to engage in cross border planning via:
  • generating foreign source income
  • averaging high and low taxed foreign income
  • reducing foreign source expenses

• Treasury Reg. § 1.861-8 (adopted in early 1980's) tried to prevent this planning by requiring allocation of expenses to FSI

• The 1986 Act reductions in tax rates dramatically increased the amount of excess FTCs for most companies
  • Foreign tax rates in countries such as Germany, Canada, Japan, and France substantially exceeded U.S. rates.
  • In anticipation of this result, the 1986 Act included a number of provisions that tried to restrict FTC planning

• Notwithstanding, between late 1980's-mid-1990's the level of excess FTCs of U.S. MNCs was substantially mitigated for profitable companies
International Tax Planning: The 80s and 90s

- **Deferral**
  - Most important for companies with low-taxed, high-profit foreign manufacturing facilities (e.g., pharma and tech with subsidiaries in Ireland or Southeast Asia)
  - Even in these situations, the importance of deferral could be reduced by section 482 (super-royalty regulations)
  - Also important to companies with excess FTCs either because of consistently high foreign tax rates or U.S. losses (NOL or OFL)

- **Goal**
  - Maximize foreign taxes that can be taken as credits notwithstanding FTC limitation
  - Attempt to keep effective tax rate on foreign income at least no higher than U.S. rate

- **Techniques**
  - Average different types of high and low taxed foreign source income
  - Increase foreign source income
  - Reduce the allocation of expenses to foreign sources
  - Reduce foreign taxes
Late 1990s - 2017

• Tax Planning Goals
  • By the late 1990's for most US MNC’s, excess credits no longer a major concern
  • Until CTB regulations (1997), obtaining a tax rate on foreign income that was below U.S. 35% rate was very difficult unless could locate profitable manufacturing activities in low tax jurisdictions or utilize contract manufacturing arrangements.
  • After CTB regs: hybrid entities allowed taxpayers to reduce their tax rate on foreign income below 35%
  • Leads to exponential growth in amount of income deferred by U.S. taxpayers

• Hybrid Entities
  • A legal entity taxed as a corporation by a foreign country, but treated as a pass-through entity by the U.S.
  • "reverse hybrid“: an entity that is treated as a partnership or other pass through entity by a foreign country but is treated as a corporation by the U.S.
Pre TCJA U.S. Tax System characteristics

- FP
- Worldwide taxation
- Tax on repatriation
- Deferral of tax on earnings
- Lax CFC rules
- Weak earning stripping rules
- 35%
Pre-2018 U.S. International Tax System: Results

- FP (Moving factories offshore)
- FC (Inversions)
- High value IP sent offshore
- Earnings stripping via Interest + service fees
- U.S.
- FC
- CFC
- "Lockout" $3TrOffshore
- Foreign to foreign profit shifting
- (Moving factories offshore)
2017 Reform: Goals & Outputs
TCJA Goals

• Encourage U.S. job growth
• Increase U.S. GDP
• Keep intangibles in the United States
• Keep U.S. headquartered companies in the United States
• Make the U.S. tax system “more competitive”
• Prevent base erosion?
• Improve transfer pricing?
Achieving Tax Policy Goals: The Politics

• Republican control of House, Senate, Presidency
• Failure of health care legislation (Obamacare repeal)
• Failure to accomplish any other major legislative initiative
• Lower rate on pass-through income
• Growth projections from tax cuts
• Bipartisan ideas, partisan efforts
Achieving Tax Policy Goals: The People

• A President who doubled down on reform
• A Speaker of the House who had strong interest in tax reform
• A chairman of Senate Finance Committee who had spent a lot of time on tax reform proposals
International Reform: Main Features

• Lower corporate rate: 35% to 21%
• Interest expense limitation: 30% of EBITDA
• Participation exemption
  • 100% dividends received deduction (limited availability)
  • Territorial?
• Global Intangible Low-Taxed Income
  • Expansion of subpart F
  • Minimum Tax?
  • Immediate taxation of most foreign earnings at 10.5% rate
  • Reduced FTC availability
• One-time transition tax
International Reform: Main Features

• Foreign Derived Intangible Income
  • Lower tax rate on exports or income derived from services income if provided overseas

• BEAT
  • Corporate min tax on outbound payments

• Anti-hybrid rules

• Restrictions on outbound transfers of assets

• Greater authority for government in transfer pricing cases?
Implementation of Goals

• Territorial
  • Discussed for many years
  • Concerns over territorial & base erosion
  • GILTI arguably means of ensuring no deduction for expenses allocable to non-taxed foreign earnings

• Base erosion concerns
  • BEPS: Check-the-box rules
  • GILTI: limits ability to profit-shift overseas
  • Interest expense limitation (BEPS)
  • Anti-hybrid rules (BEPS)
  • BEAT
Implementation of Goals

• Foreign derived intangible income deduction
  • Keep IP in the US

• Immediate tax on foreign earnings
  • Prevent base erosion
  • Revenue raiser

• Restrictions on ability to transfer intangibles offshore
  • Keep intangibles in the U.S.

• Lower corporate rate
  • Make the U.S. tax system more competitive
New Participation Exemption

• The U.S. version of a participation exemption is an odd creature (a hybrid)
  • 100 percent dividends received deduction
  • Only available to corporate shareholders
  • Only available to owners of 10 percent owned foreign corporations
  • Not available to income earned in branch / unincorporated form
  • Not available upon sale of foreign corporation, except to the extent of accumulated earnings & profits
  • Not available for hybrid dividends

• And really (as further explained in next section) only available to very limited part of CFC earnings
Deferral, Eliminated?

• GILTI = Global Intangible Low-Taxed Income
• New section 951A of the Internal Revenue Code
• Subjects “net tested income” of CFCs to tax at ½ the corporate rate (rate to increase in 2026)
• Differs from subpart F rules (and most countries’ CFC rules) in important ways:
  • “Character” of income is irrelevant
  • Any amount in excess of fixed return (10%) on basis in tangible assets
  • Cross-crediting allowed, but see following section re foreign tax credits
  • CFC tested net income an aggregate concept
New baskets

• The GILTI basket
• The foreign branch basket
• Creates additional complexity
100 percent creditability: no more

• GILTI basket credits: limited to 80 percent of “attributable” credits
• No carryback / carryforward to GILTI credits
• US shareholder expense allocation – results in further reduction in ability to claim foreign tax credits
• Query: impact on US multinationals foreign tax planning?
Separate Entities

- TCJA calls principle of separate entities into question in fundamental (but hidden) ways:
  - GILTI tax imposed on “net CFC tested income” basis
  - Income of profitable CFCs “smashed” together
Where did GILTI come from?

• Back in 1962, some had proposed ending deferral altogether
  • This obviously was not adopted

• Beginning in late 1990s, serious consideration being given to U.S. adopting a territorial system
  • Acknowledgement that need tight base erosion rules to combat this
  • Expansion of subpart F rules seen as way to do that

• Chairman Camp bill: immediate taxation on “intangible based income”

• Obama budgets: “minimum tax” foreign earnings
Is GILTI a Worldwide-Minimum Tax?

• Stay tuned!
Questions & Next Steps
Questions on Reform Provisions

• Sustainability
• Lower corporate rate
  • Sustainable?
  • Wacky § 199A: sustainable?
• Lower rate on GILTI:
  • Phase-out
• Lower rate on FDII
  • Phase-out
• WTO/OECD objections
Questions on Reform Provisions

• GILTI
  • Needs implementing regulations
  • Expense allocation
  • Basketing
  • MNC responses? More inversions
  • Other countries to copy

• BEAT
  • More outbound impact than inbound
  • Services
  • Needs implementing regulations
Larger Impact Questions

• Competitiveness?
• Jobs?
• Intangibles?
• Investment into U.S.?
• Global distortions?
• Other countries responses?
• BEPS and digital
2018 and Beyond ...