TP WEEK

US tax bill introduces new transfer pricing regime

As the US tax reform bill passes its final stages in Congress, a new transfer pricing regime becomes apparent with the establishment of a new base erosion and anti-abuse tax (BEAT) and a controversial new tax on intangibles (GILTI).

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The bill, much coveted by President Donald Trump, makes fundamental changes to the taxation of multinationals and moves the US to a territorial tax system for taxing foreign-source income from domestic MNEs. Following the Senate's adoption of the Tax Cuts and Jobs Act on Wednesday, *TP Week* takes a look at the key provisions related to transfer pricing and their implications for businesses.

Most of the bill's provisions are effective for tax years beginning after December 31 2017, ringing in the new year for transfer pricing professionals with new controversial measures aimed at intangibles and profit shifting.

Intangibles

The bill introduces a minimum tax on global intangible low-taxed income (GILTI) by US shareholders (**Section 14201**), which the government expects to raise considerable revenue. GILTI is, generally, the excess of a shareholder's controlled foreign corporation's net income over a routine or ordinary return. This will impose a minimum tax of 10% on excess profits from what is perceived to be offshore intangible income. Corporate shareholders are allowed to deduct 50% of GILTI from 2018 until 2025, and 37.5% from 2026.

"The incentive remains for companies to keep their intangible income in non-US jurisdictions with lower tax rates," Mike Heimert, global transfer pricing leader at Duff & Phelps in Chicago, told *TP Week*. "Because sales or transfers of existing intangible property out of the US now requires the inclusion of goodwill, going concern-value, and workforce in place within the definition, and that intangibles can be valued using the conceptual framework of 'realistic alternatives', some US companies that have not already transferred their intangibles to the US may find it to be more costly, without proper planning, to now do so."

"In addition, with intangible property that is outside the US, when coupled with the OECD BEPS initiative, there will be a greater desire to have intangibles reside in jurisdictions where the company can demonstrate it has DEMPE functions," Heimert added.

Richard Phillips, senior analyst at Washington DC-based non-profit research organisation Institute on Taxation and Economic Policy, told *TP Week* the new tax on GILTI leaves room for profit shifting.

"The global intangible tax really hits any profits based on extraordinary profits based on the amount of intangible assets you have. The way it functions is that you have to pay a 10.5% rate on the profits earned beyond a 10% return on investment based on the amount of intangible assets you have. So if you have $100 million of intangible assets, you get $10 million of profits that goes untaxed. The rest gets a 10.5% rate on it," Phillips said.

"This policy, although it is better than not having any, doesn't raise that much money. Also, because it's applied on a global basis, it allows companies to actually shift from one country to another as the rate they achieve is lower overall or around the 10% rate. We think it leaves a lot of opportunity for tax avoidance to continue."

Going it alone – BEAT

The bill introduces a new tax intended to curb aggressive profit shifting, called the base erosion and anti-abuse tax (BEAT). It will be applicable to domestic corporations, apart from S corporations, regulated investment companies and real estate investment trusts, whose group profits are at least $500 million of annual gross receipts, that make payments to foreign affiliates that result in deductions equal to 4% or more of their total deductions.

The BEAT tax liability is calculated through a formula to find the base erosion minimum tax. The amount of tax is equal to the excess of 10% of the taxpayer's modified taxable income for the taxable year, or 5% in the case of taxable years beginning in calendar year 2018, over an amount equal to the taxpayer's regular tax liability for the taxable year (but not below zero) by any credits. This does not include the research credit and a certain amount of applicable Section 38 credits.

"The provision is expected to affect certain industries disproportionately. In particular, with the explicit inclusion of related-party cross border reinsurance, which is very common within the insurance industry, large segments of the insurance market could be very significantly impacted," KPMG said in a **statement**.

The BEAT is causing concern among both corporates and politicians abroad as it does not align well with existing international regulation and may result in double taxation.

Phillips said the BEAT could be an effective measure. “But, when you take the two new minimum taxes [the BEAT and the minimum tax on GILTI] and add them together, they still don’t add up to enough to outweigh the impact of the territorial tax system, according to the analysis of the Joint Committee on Taxation (JCT),” he said. “The BEAT has a lot of issues. It very likely violates tax treaties and World Trade Organisation rules. Although it’s a good idea, it might actually be wiped out entirely after a challenge [by the EU].”

EU finance ministers from Germany, UK, Spain, Italy and France expressed concerns about the BEAT in a letter to Secretary of the Treasury Steven Mnuchin earlier in December. The ministers said it “may lead to significant tax charges and may harmfully distort international financial markets” and could potentially be “extremely harmful” for international banking and insurance business, which would be among the sectors most affected by the BEAT. “It is important that the US government’s rights over domestic tax policy be exercised in a way that adheres with international obligations to which it has signed-up,” the ministers wrote.

Business income deduction for pass-through entities

The bill offers a temporary tax break for business income earned by pass-through entities, including non-corporate owners of certain partnerships such as individuals, trusts or estates, and S corporations and sole proprietorships. If you fall into one of these categories, you will be able to claim a 20% deduction against qualifying business income. This provision expires for tax years beginning after December 31 2025.

Heimert of Duff & Phelps said this provision would make it advantageous to set up separate related entities within the US for certain types of professional services businesses in order to reduce the overall effective tax rate for the owners of the business. “Thus, there will be an increase in US domestic transfer pricing activity to set up arm’s-length pricing between two US entities in those instances,” he said.

Joe Kennedy, senior fellow at Washington DC-based think-tank Information Technology and Innovation Foundation, which is chaired by Senator Orrin Hatch, was not convinced by this policy. “It will create all sorts of perverse incentives for people who incorporate their business and try to work as contractors rather than employees. An employee is going to pay substantially more tax than someone who does the same work but is an independent contractor and I think that’s bad policy,” he told *TP Week*. “I’m not convinced that the IRS is going to be able to effectively police that, and it’s not going to have much effect on growth – it’s going to result in a lot of revenue loss.”

Corporate income tax rate

The corporate income tax rate will be 21%, a compromise from the previous headline rate of 20%, and generally well received by the business community. This drastic cut from 35% has been the **subject of much discussion** over the past year, with pro-business groups and politicians claiming it is a necessary move for a competitive economy, while others have criticised it for encouraging a global race to the bottom on corporate income tax rates.

"Getting the rate down to 21% is a very important achievement and really necessary if the US wants to keep companies and also encourage more investment from abroad," Kennedy said. Meanwhile Phillips argued the idea that the corporate income tax rate was holding the US economy back was not necessarily true.

"Although having a low rate might bring in some investment, there is a risk that US multinationals will have a real incentive to move their money offshore now [because of some of the other provisions in the bill]," Phillips said.

Moving to a territorial tax system

The Tax Cuts and Jobs Act is getting rid of the current worldwide tax system and moves the US towards a territorial system for taxing foreign-source income of domestic MNEs. As a transition to the new system, the bill requires repatriation of certain previously untaxed earnings at a rate of 15.5% for earnings attributable to liquid assets and a rate of 8% for earnings attributable to illiquid assets.

Phillips said the move to a territorial tax system meant the active income of a US multinational will no longer be taxed. "We see that as a huge problem because we believe this will give companies a big incentive to continue to shift more of their profits offshore, and to move some of their real operations offshore since they won't be paying any taxes on it," he said.

However, Kennedy said the move towards a territorial system was good. "We're not going to be imposing a very high tax rate on profits earned overseas, and I think that's likely to both reduce the amount of profit shifting and also to make it easier for companies to justify staying in the US and keeping their production and research in the US," he said.

The JCT has estimated that the tax reform will create a budget deficit of $1.4 trillion over a 10-year period, while only increasing output by approximately $483 billion through an average 0.7% increase over the same period.

$1.4 trillion narrowly meets the budget resolution but opinions differ widely on whether this is sensible or not.

"We believe it's not the size of the debt, but the debt in relation to GDP that matters, so if you have higher growth, even if it comes with a little higher deficits, it's not such a big problem. But we don't think that justifies blowing a huge hole in the deficits in using the money basically to give tax breaks to wealthy people and hope that there will be growth," Kennedy said.

The latest bill can be found **here** and potential amended bills can be looked up **here**.

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