International Tax Reform: Potential Adverse Impact to your Business

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There's an old tale about a wisdom-seeking, young businessman, who looks to an older and benevolent squire for advice. The old man famously quotes, "follow the money, and the secret will be revealed." That statement is as true today as it ever was. Business owners and their advisors need to follow the money and keep a close eye on how the political interests, internationally, can provide an advantage or pitfall for most any business.

In fact, we should all be closely following the various proposals for "international tax reform." Salacious articles continue to appear in the news. The most recent is a report from a watchdog group accusing Walmart of holding $76 billion outside the United States. Of course, media reports contain implied accusations of wrong doing, while providing no actual evidence that Walmart has violated any tax laws in the United States or any other country. Coupled with a political climate of individuals and parties searching to make a splash in the coming elections, "tax reform" has become a rally cry that will last for months or years to come.

International tax reform is a common political topic in the United States. The President has proposed reforms in the area in almost every one of his State of the Union addresses. Congress has also taken up the subject on a number of occasions with a variety of reform proposals. In all cases, the proposals have stopped without significant progression. Most recently, the media-enhanced "rush" to invert United States multinational businesses and relocate headquarters outside the country for tax purposes has put the issue of United States global tax policy under a spotlight.

Will your business be internationally competitive if additional tax is added to your costs? Presidential and Congressional proposals have generally included additional or minimum tax on U.S. companies who reinvest or retain foreign earnings outside the Country. The most recent proposal by the President in the 2015 State of the Union address was an annual minimum tax of 19% (with allowance for an 85% foreign tax credit) on future earnings. The proposal is an obvious grab at the accumulated foreign earnings of companies like Apple, Amazon, and Medtronic. However, the President's (and most other) proposals refuse to address the elephant in the room: the United States taxes corporate earnings at the highest rate of any developed economy – 35%. Therefore, all businesses need to consider the potential of an additional tax on foreign earnings.

To add confusion and debate, enter stage left, the Organization for Economic Cooperation and Development (OECD), an international organization made up of 34 countries. The OECD mission is to encourage economic progress and world trade. The United States along with most of the largest economies of the world are members. They meet regularly and jointly address issues and strategies.

One of the significant issues for world economies has been utilization of income tax planning by businesses and governments to gain a global economic advantage. In many countries, tax policies have shifted toward beneficial rates in an attempt to attract business. It is not uncommon for a global business to make structural and economic changes in exchange for a significant tax savings. Look no further than the January 2015 merger of Medtronic and Covidien into an Irish parent company to see the significant tax and cash savings available outside the United States. The Medtronic transaction was designed and implemented to save significant U.S. tax on earnings reinvested outside the country.

Tax planning is not strictly the domain of larger businesses. Tax planning, export incentives, and opportunistic structuring create tax benefits for all sizes of U.S. businesses. Planning and utilization of

opportunities allow U.S. businesses to compete on a similar playing field as our trading partners.

One of the planning opportunities available to U.S. companies and companies from our trading partners has been the use of base erosion and profit shifting (BEPS) techniques to save tax. The term refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low; resulting in little or no overall corporate tax being paid. To address the issue, the OECD (with the United States participating) has spent years on the BEPS Project to explore tax-planning techniques and develop recommendations and plans to combat perceived abuses and ensure countries "retain their tax base."

The OECD has announced 15 recommended actions to address perceived abuses. The recommendations include action plans as follows:

1. Increase documentation and disclosure of business activities in participating countries;
2. Address tax impact of digital economy;
3. Neutralize benefits of hybrid financial instruments (i.e. debt in one country and equity in another);
4. Strengthen controlled foreign corporation rules;
5. Increase substance and transparency to defeat harmful tax practices;
6. Prevent treaty abuse;
7. Limit artificial avoidance of permanent establishment status;
8. Revisit transfer price rules to ensure outcomes match location of value creation;
9. Address intangibles and perceived abuse

Adoption, modification, and implementation of the actions will be placed upon participating countries.

By now, there should be alarms going off in your head. Most of these recommendations and actions were developed and written by OECD countries with little input from the United States. As with the old saying, "follow the money," the U.S. system of tax is incongruent with the goals of the BEPS project. The proposed rules place a great emphasis on having "feet on the ground" to obtain the lower tax rates and other benefits offered by OECD countries. In many countries, special tax schemes are in place to provide significant financial savings for developing technology or innovate within the country (i.e. the patent box in the United Kingdom).

Furthermore, most countries use an exemption system to allow corporate earnings taxed in another country to be returned without additional tax. Many treaties have been reformatted to allow free flow of dividends between trading partners without the additional tax of a withholding. In addition, the U.S. is one of the only major economies that continue to tax based on location of incorporation rather than location of earnings. The so-called global tax system combined with the highest corporate tax rate of any developed economy puts a significant burden on U.S. businesses, and the recommendations of the BEPS project will further steer capital and employment outside the U.S. and toward countries that recognize the importance of business in their economy.

Unless leaders in Congress along with the President abandon policies of vilification and punitive and quickly develop and adopt international tax reform, we will be "following the money" outside the United States, along with innovation, technological development, and employment.

If you do business outside the U.S., or plan to, engaging an experienced tax advisor is an investment that will pay quickly pay for itself. Experienced advisors are well-versed in the implications of tax reform measures and can help you assess your current international structure against "reform" proposals, and then , in most situations, recommend steps that can be taken to minimize the potential impact to your business.

If you'd like to explore what a international tax advisor can do for your business, start with us. Contact chad.koebnick@lharrispartners (or 952.944.3303) for a complimentary discussion.

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