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GLOBAL TAX WEEKLY

a closer look

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SUBJECTS TRANSFER PRICING INTELLECTUAL PROPERTY VAT, GST AND SALES TAX CORPORATE TAXATION INDIVIDUAL TAXATION REAL ESTATE AND PROPERTY TAXES INTERNATIONAL FISCAL GOVERNANCE BUDGETS COMPLIANCE OFFSHORE

SECTORS MANUFACTURING RETAIL/WHOLESALE INSURANCE BANKS/FINANCIAL INSTITUTIONS RESTAURANTS/FOOD SERVICE CONSTRUCTION AEROSPACE ENERGY AUTOMOTIVE MINING AND MINERALS ENTERTAINMENT AND MEDIA OIL AND GAS

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GLOBAL TAX WEEKLY a closer look

Global Tax Weekly – A Closer Look

Combining expert industry thought leadership and the unrivalled worldwide multi-lingual research capabilities of leading law and tax publisher Wolters Kluwer, CCH publishes Global Tax Weekly — A Closer Look (GTW) as an indispensable up-to-the minute guide to today's shifting tax landscape for all tax practitioners and international finance executives.

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Topicality, thoroughness and relevance are our watchwords: CCH's network of expert local researchers covers 130 countries and provides input to a US/UK

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Alongside the news analyses are a wealth of feature articles each week covering key current topics in depth, written by a team of senior international tax and legal experts and supplemented by commentative topical news analyses. Supporting features include a round-up of tax treaty developments, a report on important new judgments, a calendar of upcoming tax conferences, and "The Jester's Column," a lighthearted but merciless commentary on the week's tax events.

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CONTENTS

FEATURED ARTICLES

The Foreign Earned Income Exclusion – A Coat Of Many Colors: Part II

Nathan Mintz, Esq., Ephraim Moss, Esq., and
Joshua Ashman, CPA, Expat Tax Professionals

5

Preliminary Comments On Proposed US Tax Reform

Paul Tadros, Marc Schwartz and Richard Hartnig,
Schwartz International

10

Singapore Budget 2017

Stuart Gray, Senior Editor, Global Tax Weekly

15

Topical News Briefing: Fractured Kingdom

The Global Tax Weekly Editorial Team

26

New Zealand To Enact Tighter Foreign Trust Disclosure Rules

Marcus Hinkley, Withers

28

Sixth Circuit Sets Limits On The Application Of The Substance-Over-Form Doctrine

David Sherwood and John Robert,
McDermott Will & Emery

30

Recent Tax Developments In Nigeria

Taiwo Oyedele, Kenneth Erikume and
Ajibola Ogunlana, PwC, Nigeria

32

Topical News Briefing: Good Hope In Short Supply

The Global Tax Weekly Editorial Team

35

NEWS ROUND-UP

UK Tax Devolution

37

Scottish Parliament Agrees New Income Tax Settings

Northern Irish Government Mulling 10 Percent CIT Rate

Unique Scottish Tax Rules Add To Complexity

Income Tax Reform

39

Oman Increases Corporate Income Tax Rate, Scope

Philippines Hopes To Overhaul Tax Code By 2018

Czech Ruling Party Proposes Progressive Taxes

Macron Sets Out Tax Policies For France

Switzerland To Draw Up New Corporate Tax Plan

Preliminary Comments On Proposed US Tax Reform

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Introduction

There's been a lot of talk over the past several weeks about potential tax and trade reform in the US, ranging from an income tax overhaul, to border adjustment taxes and broad tariffs. This article has three goals:

- (1) Explain a VAT in layperson's terms;
- (2) Dispel the notion that a VAT and tariff/border adjustment tax are similar; and
- (3) Assess the proposed tariff and border tax adjustment systems.

Keeping in mind that the tax proposals are designed, in part, to encourage increased US manufacturing, it is important to note that, since the late 1980s/early 1990s, the US economy was already shifting away from a primarily manufacturing economy to a services one. High-end specialized equipment manufacturing is still carried out in the US, while low-end manufacturing of primarily consumer goods (*e.g.*, refrigerators, washing machines, *etc.*) has been sourced out to lower-cost jurisdictions.

This article refers to a foreign-based manufacturer as FC. USC is a US importer or exporter.

VAT System

As there is talk about a border adjustment tax being analogous to a value-added tax ("VAT") we thought it might be useful to describe a typical VAT and compare it to one of the current proposals. In extremely broad terms, think of VAT as analogous to a sales tax. The basic premise of

a VAT system is that the ultimate burden is borne by the last person in the supply chain, *i.e.*, the final consumer. For example:

1. FC purchases raw materials to manufacture product X. FC pays VAT to the seller, manufactures X and is ready to sell.
2. FC sells X and charges and collects VAT from the buyer.
3. FC then nets VAT collected from its customer against VAT that FC paid when it purchased the raw materials (referred to as "input credits") and remits the net amount to the government.
4. Suppose FC sells X to a retailer. The retailer credits the VAT it paid FC *versus* the VAT collected from the end-user customer, who does not get a VAT credit.

This can be further illustrated by the following numerical examples:

VAT Example: Rate of 20 percent	
1. FC purchases materials for 100	
2. FC sells to wholesaler finished product for 150	
3. Wholesaler sells to retailer for 170	
4. Retailer sells to consumer for 200	
The total VAT will be 40 (20 percent of 200) totally borne by the consumer	

	FC	Wholesaler	Retailer	Consumer
Purchases	100	150	170	200
VAT on initial purchase of materials by FC	20			
VAT on value added through the supply chain:				
FC to Wholesaler	10	[20 percent of (150 – 100)]		
Wholesaler to Retailer	4	[20 percent of (170 – 150)]		
Retailer to Consumer	6	[20 percent of (200 – 170)]		
VAT paid by Consumer	40	[20 percent of 200]		

(*Note:* There are varying VAT rules for import and export. For instance, when FC buys the raw materials, FC pays VAT regardless of whether it imports the raw materials. If imported, FC pays VAT at the port-of-entry to Customs or *via* a separate self-assessment mechanism. Many countries have a 0 percent VAT tax rate on exports.)

Regardless of whether FC exports X, *FC is still subject to full corporate income tax on the income from the export sales*. Furthermore, when FC exports and there is a 0 percent VAT on exports, FC's country of residency does *not* collect VAT, meaning the government of the exporting country is the one forgoing the revenue. This is important as some question whether any of the proposed US tax ideas create a subsidy for US companies that might lead to objections in the World Trade Organization (WTO). The typical VAT described above is not a subsidy, particularly as shown that the home country that exports foregoes VAT revenue, not income tax revenue. Is the forgone VAT a subsidy? Doubtful when put into the following context: USC manufactures in, say, California and such sales are normally subject to sales/use tax; if USC exports its finished products to, say, the UK, it does not charge the sales/use tax.

Border Adjustment Tax ("BAT")

Introduction/Assumption

The limited written guidance ¹ provides changes to the income tax where the: (1) cost of imports would not be deductible notwithstanding that domestic sales of those products will be taxable; and (2) income from exports would be tax-exempt. As mentioned, these two items could face scrutiny by the WTO. Separate from the BAT but as part of the tax reform, both the Republican-led Congress and the Trump Administration desire to reduce corporate and individual tax rates.

Imports Not Deductible

Suppose USC imports finished goods to resell in the US. Currently, USC can deduct the cost of the imported goods. Under the BAT proposal, the income is taxable but its material expense (the imported goods) is not deductible, resulting in tax on essentially gross income. USC will likely need to raise prices or suffer material economic and cash losses, above and beyond facing increased shareholder pressure. In any case, US consumers may suffer due to higher prices, USC may suffer if it cannot fully increase prices and, in such case, is the US better off?

We commend the Trump Administration for a goal of increasing simplicity in the tax code, so let's hope that the rules created to track relevant items are user-friendly. For instance, what if USC's total costs are split 50/50 between domestic/import expenses and its sales are split 80/20 between domestic/exports. Will there be a significant administrative burden?

Exports Excluded From Taxable Income

Invariably, if export sales gross revenue is excluded, then the associated costs (including overheads) must also be excluded, not only due to world trade rule considerations, but also in the fairness of the tax system and revenue neutrality.

Remember that most US manufacturing is for high-end items, requiring skilled labor. If USC primarily exports, it and its shareholders have gained a substantive tax advantage over domestic enterprises. Will we see a reduction (or a smaller increase) in new enterprises manufacturing for the US market and likely hiring US workers?

If USC's markets are both export and domestic, given that it will be taxed on domestic sales while not being able to deduct the costs associated with export sales, it may need to increase its price to domestic purchasers.

Separately, implementing a VAT on imports and still allowing an income tax deduction for import costs is something that may be a compromise minimizing some of the potential negative results from the BAT.

Tariffs

The Trump Administration hopes that imposing tariffs will increase US manufacturing. The theory is that tariffs increase costs for US importers, increasing the attractiveness of US production. Tariffs also raise prices for the end-consumer, particularly if US trading partners respond in kind. So, even if the US implements tariffs, consumers across the globe will pay the cost – US consumers included. Price increases are likely to lead to wage pressure, both fueling inflation. One of the sectors the Administration is trying to protect, the blue collar middle class, may get hit the hardest.

It is unclear what tariffs may do *vis-à-vis* the US dollar's value, given the uncertainty of what other countries may do. For instance, in Mexico for recent meetings, we learned that Mexico and other trading partners are making alternative import/export plans in case the US imposes tariffs. Thus, we do not believe pure tariffs are necessarily a positive alternative, as indicated in the conclusions.

Conclusions/Observations

There seems to be a misperception that the dollar will become stronger, thus reducing the negative effects due to the tariffs on imports/non-deductibility of imported goods. Some questions:

1. Has consideration been given to the potential damage to exports by becoming more expensive and negatively impacting competitiveness?
2. What will be the effect on foreign direct investment in the US? Will it be decreased if our trading partners see a more unfriendly environment?
3. Will tourism to the US be negatively impacted by a possibly stronger US dollar?
4. What about business conferences, *etc.*? Venues in other countries may be sought instead.
5. The record keeping and administrative burdens on business and the IRS will increase. Is the Code being simplified or are we just replacing one set of complex rules with another?

ENDNOTES

- 1 *A Better Way: Our Vision for a Confident America*, Tax, June 24, 2016, better.gop – a 35-page document outlining tax reform proposals and background.