

# China Tax Alert

Issue 30, November 2017



## US House of Representatives pass landmark tax reform bill

### Regulations discussed in this issue:

- H.R. 1, the "Tax Cuts and Jobs Act", passed by the US House of Representatives on 16 November 2017 (House Tax Bill)
- Modified Senate Tax Reform Bill, prepared by the Chairman of the Senate Committee on Finance and released on 14 November 2017
- KPMG's analysis on House tax reform bill (H.R. 1), released on 16 November 2017

Click [here](#) to read the full report.

On 16 November 2017 the United States ('US') House of Representatives passed a landmark tax reform bill by a vote of 227-205. The passing of the House Tax Bill proposes a sweeping overhaul of the US tax system, the most significant changes since 1986, but is by no means the end of the process. It is now further required that the US Senate pass their own bill, that the House and Senate bills are aligned through negotiation and passed in identical form by both bodies, and that the US President signs the bill into law. Many hurdles lie in the way of making the tax reforms law, but the Trump Administration still aim to do this by Christmas 2017.

From a China perspective, the most relevant changes are those made to the US corporate tax ('CT') cross-border provisions. These could have a significant impact both on Chinese investors into the US, and on the competitiveness of Chinese multinational enterprises (MNEs) vis-a-vis their US headquartered counterparts. The planned US CT changes also feed into the wider global discussion on the shape of the future international tax rules applying to all countries, and so also impacts indirectly on China's own tax policy choices. Highlights of the international tax rule changes are set out in this alert.

### US House Tax Bill main changes

The House Tax Bill provisions may be segmented into individual tax, business tax and international tax changes – we note those of potential China interest.

#### *Individual and business tax changes*

- The federal CT rate is lowered from 35% to 20%, bringing it below the OECD average. The change would be effective from January 2018.
- A revised, but complex, new set of rules for 'pass-through' businesses (i.e. sole traders, S-Corps, LLCs, partnerships) is introduced. This provides a competitive marginal 25% rate for 'qualified business income', in the place of current personal income tax (PIT) rates up to 39.6%.

- 100% expensing of capital asset investment is allowed in the period 2017-2022, though real estate assets are excluded.
- A limitation on interest expense deductions caps these at 30% of earnings before interest, tax, depreciation, and amortization (EBITDA). This rule draws on OECD BEPS Action 4. The existing earnings stripping rules are abolished. There are exemptions for small firms and real estate businesses.
- Carry forward net operating losses (NOLs) are limited to offset 90% of taxable income in any year, and loss carry backs are substantially abolished.
- A new 3 year holding period for preferential carried interest treatment.
- PIT rates and bands are reformed, many PIT/CT special deductions/credits are abolished, and Alternative Minimum Tax and Estate Duty are scrapped.

#### *International tax rule changes*

Major changes are made to both how US MNEs are taxed on their foreign operations and how foreign companies are taxed on US activities.

- A 100% CT exemption is provided to US companies on their dividends from foreign subsidiaries (10% equity holding required). Historic accumulated earnings in foreign subsidiaries are subject to a one-off tax on a deemed repatriation. This applies at 14% on cash and at 7% on illiquid assets.
- Expanded controlled foreign corporation ('CFC') rules subject the bulk of the profits of overseas subsidiaries of US MNEs (so-called 'foreign high returns') to a 10% current year tax. A US foreign tax credit is provided for 80% of the foreign tax applied to subsidiary income, meaning that no further US tax should apply as long as the foreign effective tax rate ('ETR') is at least 12.5%.
- A highly novel rule subjects outbound payments by US companies to foreign related parties to a 20% excise tax. This affects outbound payments by groups preparing consolidated financial statements, where the payments by US group members exceed USD100m annually. The rule applies to payments which are includable in cost of goods sold or in the basis for depreciable assets. There are exclusions for intra-group services paid for at cost, interest and commodity payments, and payments subject to full 30% withholding tax. However, the foreign company can instead make an election to recognize a deemed permanent establishment ('PE') in the US. This would then be taxed on a profit margin reflecting the profitability of the foreign operations of the relevant group product line, as per the global financial statements. There is a foreign tax credit of 80% of the foreign tax.
- A worldwide debt cap interest limitation rule, also drawn from BEPS Action 4, is introduced. This limits net interest expense deductions to the extent that the US company share of an international group's global net interest expense exceeds 110% of the US share of the group's EBITDA.

#### **KPMG observations**

The House Tax Bill contains many innovations which break with historic US tax practices. The changes move the US towards a territorial system, with dividend the participation exemption. However, conversely, they also move the US toward a 'true' worldwide system, with the tax on 'foreign high returns'. The outbound payments rule introduces 'destination based' taxing rights, and may impact on the OECD digital economy tax work at global level. This, together with the interest rules, would impact Chinese enterprise operations in the US, and raise tax treaty compatibility issues. Chinese tax policymakers will also be watching developments closely, and may consider policy adjustments to maintain China business competitiveness. The Senate bill differs on many points, with a different base erosion rule and a special IP income rule –closely monitoring is needed to see how the bills are reconciled.

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