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China Tax Alert

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Landmark US tax reform to be signed into law - Changes effective January 2018

Regulations discussed in this issue:

- The “Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018”, and commonly referred to as the “Tax Cuts and Jobs Act” passed by the US Houses of Congress on 20 December 2017
- KPMG’s analysis on Conference Agreement for H.R. 1, Tax Cuts and Jobs Act, released on 18 December 2017

  Click here to read the full report.

On 20 December 2017, US tax reform legislation was passed by both Houses of Congress after the US House of Representatives voted to approve the measure (the US Senate vote was the day before). The legislation, commonly known as the Tax Cuts and Jobs Act (TCJA) is expected to be signed into law by President Donald Trump on 3 January 2018. The slight delay in signing is anticipated as necessary to avoid triggering automatic spending cuts under the so-called PAYGO provision.

The TCJA is the most significant overhaul of US tax rules since 1986 and will have a profound influence on US business activity, on the businesses and economies of other countries, and on the direction of tax changes, both globally through the G20/OECD processes, and in individual countries, including China.

TCJA - key provisions

The TCJA makes many changes of purely US domestic interest – we focus primarily on those with a cross-border relevance, and Chinese interest, including:

- **Rate:** The federal corporate tax (CT) rate is reduced from 35% to 21%, effective January 2018, and the CT Alternative Minimum Tax is abolished. The new rate is below the 24% OECD average, while China’s rate is 25%.
- **Exempt foreign dividends:** A 100% foreign dividend deduction allows profits of US MNE foreign subsidiaries to be brought back to the US without further tax. This resolves the cash trap that kept USD2.6 trillion of US MNE profits overseas, and allows businesses to more flexibly redeploy their cash for investments in the US and overseas. The US joins most other major economies with such a participation exemption regime, leaving China amongst a small number of major economies (including India) that still tax foreign dividends. The US exemption is subject to anti-hybrid rules (i.e. if the payment is tax deductible overseas then no US exemption).

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- **CFC rule expansion:** At the same time, the TCJA moves to ensure that the profits of US overseas subsidiaries are subject to a global minimum tax. This breaks with the long tradition of deferring US tax until foreign subsidiary profits are brought back to the US. Under the new system, while the dividends will be exempt on return to the US, the profits will already have been taxed at the time they were earned, either by the foreign country or by the US.

  This is achieved through a 10.5% tax on income of a US overseas subsidiary (not otherwise taxed pursuant to US Subpart F rules) in excess of a 10% return on the tax basis in business property (rising to 13.125% from 2026), imposed under an expansion to US CFC rules. An 80% tax credit for foreign tax incurred means that additional US tax arises where the foreign effective tax rate (ETR) falls beneath 13.125% (16.4% from 2026).

- **IP income:** The TCJA applies a 13.125% rate (16.4% from 2026) to the IP income 'element' of sales/service income derived from overseas sources by a US company. This incentivizes US exports and locating or relocating elements of the supply chain to the US.

- **Base erosion:** The TCJA introduces a base erosion rule for outbound related party payments made within large MNE groups. This is referred to as the base erosion anti-abuse tax (BEAT). The BEAT limits the tax benefit of certain outbound related party payments using a 10% minimum tax (5% minimum tax for 2018 tax year only). The effect of the rule is that 'base eroding payments' are permitted to reduce taxable income (prior to deduction of the relevant payments) by up to 52% (when no tax credits) – beyond that the 10% tax claws back deduction benefits. From 2026 the rate is 12.5%, so relevant deductions cannot reduce the effective tax rate (ETR) below 12.5%.

  The BEAT applies to payments of interest, service charges, and royalties to overseas related parties, and includes anti-avoidance rules to stop taxpayers side-stepping the rule through use of unrelated intermediaries. It generally does not apply to goods purchases, except where these occur within an inverted US group, in which case the BEAT would apply.

- **Historic overseas profits:** The TCJA deemed repatriation tax on historic accumulated earnings applies at 15.5% on cash and 8% on illiquid assets.

  Other measures: Other significant measures include limiting of interest deductions to 30% of a measure of enterprise earnings, tax loss restrictions, anti-hybrid rules for outbound payments, expensing of assets for 5 years to 2022 (with generous phase-out), and a 20% reduction of personal income tax on income earned through pass-through entities. There are a wide range of personal tax reductions, all of which expire from 2026.

KPMG observations

The TCJA has profound implications for global business activity, both by US and foreign companies, and for tax policy at global and individual country level. From a China perspective a number of matters come to the fore:

- Many Chinese investors many see increased after-tax returns from US investments. Chinese enterprises investing in the US would see the US federal ETR on their investments reduced from 41.5% to 28.9%, inclusive of US 10% dividend withholding tax under the US-PRC tax treaty.

- The TCJA impact on the tax burdens and global competitiveness of US businesses depends on the business sector and historic commercial and tax strategies of the MNE in question. The CT reduction, asset expensing and IP export incentive will enhance the competitiveness of some firms. Others will be negatively affected by the interest deduction limitations, and by the impact of BEAT deduction limitations on their outsourced operations. For certain MNEs, which targeted very low ETRs on their overseas operations, the global minimum tax may prompt restructuring.

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- The BEAT provision may impact on the incentives for US MNEs (and other MNEs with US operations) to outsource group service activities to Chinese related parties. Chinese MNEs with worldwide operations, including in the US, may see deductions for interest, royalty and service payments from their US subsidiaries impacted, and may be prompted to restructure.
- The BEAT, and the IP export incentive, raise issues of tax treaty and WTO rule compatibility, as well as compliance with BEPS standards. European governments have already directly protested to the US government on this, and some governments may take countermeasures against the US.
- China and other countries are likely to consider tax rule changes to maintain the competitiveness of domestic enterprises, and overall investment attractiveness. Such changes could include corporate income tax reduction and new incentives. In addition, the TCJA will likely impact the current G20/OECD work on the future shape of the international tax system, which is currently being revamped for the new digitized era.

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