KPMG

HONG KONG TAX ALERT

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Prospect of US tax reform by 2017 year-end rises after Senate passes bill

Summary

Regulations discussed in this issue:

H.R. 1, the "Tax Cuts and Jobs Act" (Senate version) passed by the US Senate on 2 December 2017 (Senate Tax Bill)

H.R. 1, the "Tax Cuts and Jobs Act" (House of Representatives version), passed by the US House of Representatives on 16 November 2017 (House Tax Bill)

On 2 December 2017, the US Senate passed a tax reform bill. This follows on from the passing by the US House of Representatives of their version of the bill on 16 November 2017. Passage by the Senate had been viewed as the most challenging step for tax reform and, following this, expert opinion is that the likelihood of tax reform happening has risen considerably. House and Senate bills must now be aligned through negotiation to arrive at a 'conference report' and passed in identical form by both bodies. The President then signs the bill into law. The Trump Administration aims for passage by Christmas 2017.

The Senate bill differs from the House bill on certain key cross-border rules (i.e., those of most interest to Chinese businesses, investors and tax policy makers). Choices now need to be made on which of the Senate or House variants will be carried to the final bill. We highlight here the key differences to analyze the impact from a China perspective. See our tax alert on the House tax bill here for more background detail.

US Senate and House tax bills - key differences

The Senate bill differs from the House bill on a number of key points:

- **Timing**: The federal Corporate Tax (CT) rate reduction from 35% to 20% is effective January 2019 in the Senate bill, but from January 2018 in the House bill. The Senate, but not the House, preserve the Alternative Minimum Tax.

- **Exempt foreign dividends**: Both House and Senate bills have a 100% dividend exemption (via deduction), but the Senate adds anti-hybrid rules (i.e., if the payment is tax deductible overseas, then no US exemption).

- **Historic overseas profits**: The Senate bill deemed repatriation tax on historic accumulated earnings applies at 14.5% on cash and 7.5% on illiquid assets, vs 14% and 7% in the House bill.

- **CFC rule expansion**: As with the House bill, the Senate bill expands the CFC rules to tax the bulk of the profits of US overseas subsidiaries, as they are earned, at a 10% rate. However, this would rise to 12.5% in the Senate bill from 2026, and the Senate rule appears to catch more foreign income.

- **IP income**: The Senate bill applies a 12.5% rate (15.625% from 2026) to the IP income 'element' of sales/service income derived by a US company from overseas supplies. This is not included in the House bill.

- **Base erosion**: The Senate and House bills both introduce base erosion rules for outbound related party payments made within large MNE groups:

  - The House bill rule subjects outbound payments by US companies to foreign related parties to a 20% excise 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.

  - The Senate bill rule limits the tax benefit of certain outbound related party payments by imposing a 10% minimum tax on a modified taxable income, which is taxpayer's regular taxable income with outbound related party payments added back. Effectively only half of the modified taxable income can be reduced by utilizing outbound related party payments. From 2026 the minimum tax rises to 12.5%, meaning that outbound related party deductions would not be able to reduce the effective tax rate ('ETR') below 12.5%.

  - The thresholds for the taxes are different in House and Senate proposals – the House proposals affect groups preparing consolidated financial statements, where US group member annual payments exceed USD100m. The Senate proposal affects companies making USD500m of outbound payments, more than 4% of whose deductions are 'base eroding'. Different payments are in scope of each rule – The House rule covers payments for cost of goods sold and excludes intra-group services paid for at cost, interest and commodity payments, and payments subject to full 30% withholding tax. Comparatively, the Senate rule includes cost of goods sold, but only when paid to an inverted entity, and does not exclude interest.

- The House and Senate bills differ on a number of other measures**:**

  - Both restrict interest deductions to a percentage of annual income, and limit interest deductions where the US entity is more heavily leveraged than the worldwide group, but they differ on the calculations.

  - Both have asset expensing for 5 years, but Senate is more generous.

  - Both reduce tax on 'pass-through' entities, but in different ways, and Senate measure 'sunsets', with all personal tax reductions, from 2026.

  - Senate (but not House) bill has anti-hybrid rules for outbound payments.

The two weeks to mid-December 2017 will see intensive negotiation on these points.

KPMG observations

Both bills contain many innovations which break with historic US tax practices.

- The participation exemption moves the US towards a tax territorial system.

- Conversely, however, the CFC rule expansion also moves the US towards a 'true' worldwide system. The 80% tax credit for foreign tax means that US tax arises where the foreign ETR falls beneath 12.5%.

- The House bill outbound payments rule introduces 'destination based' taxing rights, and may impact the OECD digital economy tax work at global level. Both House and Senate base erosion rules may raise treaty and WTO issues.

- The Senate bill IP income incentive may not be in line with global tax standards on IP boxes, and may raise WTO issues.

The base erosion and interest rules could impact some Chinese enterprise operations in the US, while other Chinese investors see increased after-tax returns from US investments. The CT rate reduction and IP incentive raise questions on the competitiveness of Chinese MNEs with their US counterparts. Chinese tax policymakers will also be watching developments closely, and may consider policy adjustments to maintain China business competitiveness. Close monitoring of the bill reconciliation is needed over the next two weeks.

Click here to read more details and observations prepared by KPMG US.

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