TAX BRIEFING

US tax reforms: impact on cross-border investments

The US Tax Cuts and Jobs Act of 2017 (2017 Act), generally effective for tax years beginning after 31 December 2017, enacted sweeping reforms to the system of US federal income taxation of cross-border investments. The focus of the reforms on cross-border taxation is, generally, on outbound investments by US-headquartered multinational companies and moves from a worldwide system of taxation to a territorial system.

Brief overview of historical system

Previously, the US imposed a system of worldwide taxation on US taxpayers and imposed tax on income earned by US taxpayers regardless of the source of the income. US taxpayers could, in certain circumstances, defer current taxation on non-US-sourced income. Generally, tax would be imposed on the repatriation of non-US-sourced, tax-deferred income and, subject to complex rules, exceptions and limitations, a credit would be available for any non-US taxes previously paid on that income. The Tax Cuts and Jobs Act of 2017 abandons this system and replaces it with a system advertised as a territorial system but which is, in fact, more of a hybrid system.

Lower rates

The 2017 Act's headline change was to lower the corporate tax rate from 35% to 21%, which, apart from certain exceptions discussed below, generally applies regardless of the nature or amount of the income of the corporation. Consequently, the cost of holding non-US subsidiaries under a US corporate parent is lessened. The lower rate does not quite match the UK corporation tax rate of 19% (falling to 17% from 1 April 2020), but compares favourably with various other G20 nations, including Japan, China and France. Much of the planning historically undertaken to reduce the overall effective tax rates of cross-border investments may now no longer be necessary (*see box "Brief overview of historical system"*).

Repatriation tax

In order to avoid the permanent avoidance of taxation on current tax-deferred, non-US-sourced income, the 2017 Act imposes a one-time repatriation tax on the accumulated, deferred earnings of non-US corporations attributable to any US shareholder that owns 10% or more of the vote of that corporation. The rate of the repatriation tax is set at 15.5% for cash and cash equivalents, and 8% for other assets. The US taxpayer can elect to pay the tax in installments over eight tax years. As a result of the tax, US shareholders of non-US corporations that had large amounts of accumulated, deferred earnings will have large amounts of "previously taxed income" which enables them to avoid the imposition of any additional tax on the repatriation of any deferred earnings.

Participation exemption

The 2017 Act introduces a participation exemption for US corporate shareholders of non-US corporations. The exemption allows a US corporation that is a 10% or more shareholder in the non-US corporation to claim a 100% deduction in respect of non-US sourced dividends received from the non-US corporation. The exemption is subject to a one-year holding requirement over a two-year test period.

Planning opportunities will arise where the dividends are paid out of jurisdictions that do not levy a withholding tax such as the UK. However, unlike other comparable regimes (including the UK's substantial shareholding exemption), the exemption does not extend to capital gains on the disposal of stock, although gain on the disposal may be re-characterised as a dividend and qualify for the exemption.

This change could limit the use of holding companies in jurisdictions such as the UK, as US shareholders will have less incentive to hold investments beneath a non-US parent.

CFC changes

A non-US corporation is a controlled foreign corporation (CFC) if more than 50% of it by vote or value is owned collectively by US shareholders. Under the 2017 Act, a US shareholder includes US persons who hold 10% or more of the vote or value. Effective for the last taxable year of a non-US corporation beginning before 1 January 2018 and subsequent years, the 2017 Act also repealed a former limitation on downward attribution of ownership. That repeal will result in, among other things, a non-US corporation becoming a CFC even if it is wholly owned by another non-US corporation, if the non-US parent owns 50% or more of the value of a US corporation.

The rules in subpart F of the US Internal Revenue Code (subpart F), combined with the new rules in the 2017 Act, create essentially four categories of CFC income, which are subject to different tax rates and rules in respect of current taxation or eligibility for the participation exemption (*see box "Categories of controlled foreign corporation income"*). The rules applicable to deemed dividends for investments in US property remain unchanged.

Although companies that fall within high-tax subpart F income will continue not to be taxed under the subpart F rules, it would appear that UK subsidiaries will be caught once the UK's corporation tax rate drops to 17% in 2020. This, combined with the extension of the rules to allow for the downward attribution of ownership, could bring UK subsidiaries with a UK parent within the scope of the subpart F rules, where the UK parent also owns a US corporation. While this may seem counterintuitive, the result of the change is that, in some instances, it will no longer be possible to escape a subpart F charge by having the stock of a non-US corporation which is resident in a low-tax jurisdiction held by a parent corporation outside the US.

GILTI

Despite its misleading name, global intangible low-taxed income (GILTI) is not limited to US taxpayers that have parked intangible income in low-tax countries. It is a wholly new, broad-based tax on non-US

income, and applies to all US shareholders of a CFC, whether multinational companies or individuals. GILTI operates as a limitation on the amount of earnings that can be deferred and exempted from US tax under the participation exemption; exactly the opposite of a pure territorial system. For US corporate shareholders, GILTI is intended to be subject to a lower effective tax rate of 10.5%, which is achieved by providing them with a 50% deduction in respect of any GILTI.

Under GILTI, a US shareholder of a CFC must include in income its proportionate share of the CFC's GILTI. GILTI is defined to include most net income of a CFC, over a deemed return on the CFC's tangible assets. For CFCs in the services business, or that otherwise own little or no tangible assets, the deemed return may well be negligible. Additionally, the deemed return is reduced by the CFC's interest deductions taken into account in calculating its net income.

The net income taken into account under GILTI excludes subpart F (generally passive) income, which remains subject to the existing rules. It also excludes income that would otherwise be subpart F income, but falls within the high-tax exception (although see above in relation to UK subsidiaries in the context of subpart F). However, there is no exclusion for high-taxed income that would not be subpart F income. Therefore, GILTI applies even to the active income of CFCs operating in high-tax countries. Although foreign tax credits can reduce GILTI tax, given the manner in which GILTI is calculated, non-US taxes may not be creditable in the year that GILTI tax is taken into account by the US shareholder and there are special limitations in respect of foreign tax credits that are associated with GILTI.

In achieving a lower effective tax rate (lower than 21%) on certain types of non-US related income, such as GILTI or foreign-derived intangible income (FDII), the 2017 Act does not use a scheduler system of specified rates (*see "FDII" below*). Rather, it provides a deemed deduction intended to achieve the desired rate. Use of this deduction technique has led to complex issues involving the interaction of the net operating loss deduction, the interest deduction and the new expense deductions in determining taxable income under the 2017 Act.

Both the effect of the new GILTI rules, and their computational complexity, will mean that US investments into certain UK businesses, particularly those with a high proportion of intangible assets, will initially be less attractive than investments in the US. On the other hand, a shift in priorities of US investors may ensue, making non-US businesses with balance sheets showing a high tangible assets value more attractive, while businesses already owned by US shareholders may be encouraged to incur additional expenditure on tangible assets.

BEAT

The 2017 Act introduces a base erosion anti-abuse tax (BEAT). BEAT is an anti-abuse tool that seeks to apply a form of minimum tax, at an initial rate of 5%, rising to 10% by 2025, and 12.5% thereafter. BEAT is structured to apply only to large corporate groups with average annual gross receipts of at least $500 million over the last three years in any year in which a threshold amount of deductions are for payments to related non-US parties. The threshold creates a cliff effect: a group is either in or out of BEAT in any given year, depending on whether that threshold is met.

BEAT is triggered when an applicable taxpayer makes deductible payments to a related non-US party, such as interest, royalties and service fees, which account for 3% or more of the corporation's total deductions for the year. BEAT equals roughly the excess of 10% of the corporation's taxable income determined without regard for any base erosion tax benefit, including any net operating loss deductions attributable to those benefits, above the corporation's regular tax liability and reduced by certain permitted tax credits.

BEAT reflects a response to the US Internal Revenue Service's lack of success in enforcing transfer pricing rules. Given the unpredictability of BEAT, it is too soon to say what effect it might have on multinational enterprises, including those headquartered in, or which derive much of their value from, the UK. BEAT is very broad in that it can apply to payments whether or not they are, in fact, base eroding, and even if the non-US recipient of the payment is fully subject to tax on that payment. The rules defining "applicable taxpayers" to whom BEAT applies will need significant guidance, particularly with respect to consolidated groups.

FDII

The 2017 Act also introduces the foreign-derived intangible income (FDII) regime, which acts as an effective export incentive

Categories of controlled foreign corporation income

Controlled foreign corporation (CFC) income now falls into essentially four categories:

- Income subject to subpart F of the US Internal Revenue Code (subpart F) is taxed at the new, low 21% rate.
- High-tax subpart F income, which is subject to a "high" rate of non-US tax, is not subject to current taxation under subpart F and would be eligible for the participation exemption on repatriation.
- Global intangible low-taxed income is subject to current taxation at a lower effective tax rate (*see "GILTI" in the main text*).
- The residual income of a CFC is not subject to current tax and is exempt from tax on repatriation (*see "CFC changes" in the main text*).

for US corporations by providing a deduction in respect of FDII that results in an effective tax rate of 13.125% (rising to 16.4% after 2025) on non-US income (other than income derived from CFCs or non-US branches) generated from licensing, leasing or selling property to non-US persons for a non-US use, or from the provision of services either to a person or with respect to property, not located in the US. Like GILTI, a deemed threshold return on the underlying tangible assets that generate the income is excluded from the FDII calculation. The FDII calculation takes into account a number of variables, including whether the FDII is generated from sales or services, and so it will have different effects on different taxpayers.

As it applies to actual intangible income, the FDII regime is somewhat similar to the patent box regimes seen throughout Europe, including the UK (FDII also applies to income not typically characterised as intangible income). While GILTI may operate to incentivise US corporations to locate their tangible assets offshore, FDII is intended to incentivise US corporations to keep their intellectual property and other income-producing activities based in the US. The 2017 Act also expands the types of intangibles that are subject to current taxation on an outbound transfer to include goodwill, going concern value and workforce in place, providing a complement to FDII in the form of an additional disincentive for the outbound transfer of intangibles.

However, it remains to be seen whether the tax rate will be low enough to incentivise US corporations to eschew the regimes offered by other jurisdictions. The UK patent box, for example, can result in an effective rate of just 10% (*www.practicallaw.com/2-622-1688*). The baseline tax rate on FDII of 13.125% exceeds the baseline 10.5% tax rate on GILTI. All things being equal, the new FDII rules may not provide sufficient incentive to forego the deferral tax benefit of holding property offshore.

It also remains to be seen how the FDII regime will compare against the efforts of other jurisdictions to respond to the digital economy and how it should be taxed. The UK government has published a position paper on the subject, and has been consulting on changing the way that withholding tax is levied on royalties, essentially with a view to charging certain payments made by non-UK persons (*www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper; www.gov.uk/government/consultations/royalty-withholding-tax; see News brief "Autumn Budget 2017: keeping pace with change?", www.practicallaw.com/w-011-6628*). It is therefore impossible to determine the true effect of the FDII regime without factoring in the effects of a myriad of other changes that will be made across the globe in the coming months and years.

Related-party hybrid rules

The 2017 Act introduces a new anti-hybrid regime which has potentially far-reaching consequences. Under this regime, a US taxpayer is denied deductions for interest and royalty payments to a related party (by 50% affiliation) that either generate tax benefits to the recipient (that is, a deduction, exemption or credit) or in respect of which the related party is not subject to tax. It is expected that the scope and application of this new regime will cause US taxpayers as much uncertainty as the UK's anti-hybrid rules have caused in the UK, so significant regulatory guidance will be necessary.

New interest deduction limitation

The 2017 Act repealed the "earnings strippings" interest limitation rules that imposed a cap on the amount of deductible interest which a US taxpayer could pay to a related non-US recipient. Instead, the 2017 Act introduced a new, broader limitation on the deductibility of interest payments not limited to payments of interest to non-US related persons. Similar to many new regimes enacted as a result of the Organisation for Economic Co-operation and Development's base erosion and profit shifting project, including in the UK, the new rules limit a taxpayer's deduction for net interest expense to 30% of the taxpayer's earnings before interest, taxes, depreciation and amortisation until 2021, after which it is computed without regard to depreciation and amortisation (*www.practicallaw.com/w-009-3440*). It seems likely that these rules will be applied to the computation of income of a CFC.

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