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Understanding the New U.S. Tax System

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At a January 23 forum hosted by the San Francisco Business Times, panelists Javier Salinas, managing director of international tax services at BPM, and Michelle Ferreira, managing shareholder of Greenberg Traurig's San Francisco office, discussed motivations for the 2017 tax code overhauls, strategies to help businesses make the most of the new laws, and how some high-net-worth individuals are responding to the changes. The discussion was moderated by Andrea G. Cope, Deputy Executive Officer at CalCPA and the CalCPA Education Foundation. Below is a condensed version of the transcript. To read the full version, click here.

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SFBT: What are the factors that drove the significant overhaul to the US International tax rules with the Tax Cut and Jobs Act?

Salinas: I would identify two main factors that drove this overhaul. First, for context, the last major overhaul to the Internal Revenue Code was the Tax Reform Act of 1986, which set the corporate rate at 34 percent. In 1993, that was increased to 35 percent, where it has remained ever since. That's 25 years with the same rate. Meanwhile, other countries focused on the international perspective have significantly lowered their corporate tax rates in that time. For example, the United States is a member of the Organization of Economic Cooperation Development (OECD), an international organization that focuses on tax policy issues for cross-border transactions, among other issues. If you take OECD member states that are also European Union (EU) members, the average rate is now at 22.5 percent—far lower than where the US was before the 2017 tax cuts that became effective this year. Many saw this disparity as a significant disadvantage for the US in competing internationally with competitors based in other countries.

The other main factor driving this change was the desire to put in place measures that would help protect the US tax base. In 2015, the OECD issued its final reports concerning base erosion and profit shifting (the "BEPS" reports), which focused on cross-border transactions and how certain taxpayers were able to shift profits to other jurisdictions to avoid higher tax rates, which for the US meant structuring operations to avoid the US corporate rate of 35 percent. The reports gave suggestions for actions that various governments and their respective tax authorities could put in place to limit the shifting of profits to low-tax countries and thereby protect the tax base on which a government would assess and collect tax revenues. In keeping with a number of those recommendations, the 2017 tax overhaul includes measures that ensure highly-mobile income from activities such as research and development or assets related to intellectual property and other intangible assets are still currently subject to US tax without the benefit of deferral or exemption from US tax under the modified territorial regime, though earned through foreign affiliates.

SFBT: What are the most significant changes associated with the act?

Salinas: There are a lot of significant changes, but I'll mention two main ones. First, the US has switched from a worldwide taxation system to what's called a modified territorial regime for domestic corporations. The new participation exemption providing for a 100% deduction for certain domestic corporations receiving dividends from foreign affiliates creates this new benefit. What that means is that instead of US-based international businesses generating profits through foreign affiliates around the world and potentially deferring US tax on those profits until earnings are repatriated to the US, these businesses can potentially avoid any US tax on those foreign earnings, notwithstanding certain anti-deferral rules and rules regarding current taxation of foreign earnings the US has in place. What the US's past insistence on maintaining a worldwide tax system has arguably done is encourage companies to leave foreign profits offshore to avoid additional taxes. The hope is that this change will encourage additional investment in the US and the repatriation of foreign earnings.

Now that the US has changed to this modified territorial regime, if your business has a foreign subsidiary and the foreign subsidiary pays a dividend to the US, that dividend now is going to receive a 100 percent dividend-received deduction. That means it will not be taxed again in the US when brought back to the US and may only be subject to tax in the foreign country where earned. However, it is important to note that this is still a modified territorial system because there are still some rules in place and new rules on top of those whereby foreign derived income will still be subject to current tax in the US. Also, this dividend received deduction is not generally available to individuals, partnerships, or certain other entities owning interests in foreign companies. Accordingly, it will be important for individuals and other pass-through businesses such as partnerships and S-corporations to reevaluate the way they do business through foreign companies.

Another significant change as a result of the act is the transition tax, also referred to as the one-time "toll tax," which may impact taxpayers in their 2017 tax year. While we are shifting to a modified territorial system, it is also estimated that there are about $2.6 trillion of untaxed foreign earnings in these companies offshore. So the transition tax is focused on taking all those accumulated profits that have not yet been subject to US tax under the previous deferral system and now taxing it at one time. It is important to note that there is an election available to pay the transition tax over an eight-year period and an opportunity for S-corporations to defer the transition tax, but individuals and businesses should look now at how this transition tax will affect them. As we shift to the

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modified territorial system, domestic corporations will not be subject to US tax on those future foreign earnings once they are repatriated as dividends. However, individuals and other businesses will not generally qualify for the dividend-received deduction.

In essence, the new tax rules want to "clear the slate" and tax all those accumulated earnings that have been earned since 1986 and benefitted from tax deferral. This could obviously be a laborious task, depending on when the individual or business entity may have incorporated or invested in a foreign company. If the foreign company has been in existence since '86, there will need to be a lot of attention given to the earnings and profits calculations with respect to the foreign entities to determine the amount of profits that have not been subject to US tax and what that toll charge would be. To clarify another point, the transition tax does not require that individuals and businesses actually bring back the earnings to the US. They will be taxed whether cash is brought back to the US or not. Businesses could keep the funds offshore if that made more sense for their business operations, but tax will be assessed regardless.

Again, the law specifies that it covers the 2017 tax year, so taxpayers should recognize that they will need to address this now as they prepare to file tax returns and pay taxes in 2018. They need to perform calculations on foreign earnings subject to the transition tax and then determine the amount of the tax in order to make sure they have the cash to pay for that tax. Again, the law allows taxpayers to elect to have the tax paid over an eight-year period. That may be one way to mitigate the income tax liability that is applicable for the 2017 tax year.

SFBT: Should companies continue to own IP rights in the US or transfer those to a foreign owned entity?

Salinas: It is always going to depend on the existing structures a company has and where it does business. That being said, the US has added new measures to tax intangible property. One is a minimum tax on foreign earnings considered global intangible low-tax income (referred to as "GILTI"), which is new category of income that Congress has identified in the new rules. These rules take the income earned through a foreign subsidiary—a so-called "controlled foreign corporation"—and look at all of its income and take from that a routine return on tangible assets. The purported intent is to capture income derived from the intangible assets, but it is broader than that in effect because it does not exclude other types of income that may be unrelated to intellectual property. That income is going to be subject currently to US tax at an initial effective rate of 10.5 percent.

In what country a company should hold economic ownership of IP rights depends on the particulars of that company's operations. If a company licenses mostly to US customers, then there might not be a benefit to holding IP offshore because the company is still going to be selling in the US and may be subject to anti-deferral rules resulting in deemed dividend treatment and other unintended tax consequences.

Foreign-derived intangible income (FDII) is another new category of income that needs to be considered in cross-border transactions and is intended to incentivize taxpayers to own IP in the US. FDII refers to income earned directly by eligible U.S. corporate taxpayers from serving foreign markets and is derived from (1) sales or other dispositions of property to a foreign person for a foreign use; (2) a license of IP to a foreign person for a foreign use; and (3) services provided to a person located outside of the United States. Such income is now taxed initially at a beneficial, effective rate of 13.125 percent.

These tax rules are all effective for tax years beginning after December 31, 2017, so companies should begin to review and consult with their CPAs and other advisors to determine the most tax-efficient structure and operating model.

SFBT: How do the new limitations on business interest expense deductions work?

Salinas: The US has had rules in place limiting the interest deduction on the basis of a US company's debt-to-equity ratio with respect to financing from its foreign parent. The new tax rules create a broader limitation on the deduction of business interest, applicable both to individual business owners and to corporations.

The policy at issue relates to protecting the US tax base, and includes new measures to disallow certain deductions that would erode the reduced tax base that now exists as a result of the lower corporate tax rate. However, these changes to business interest expense deductions are broader in the sense they are not limited to certain foreign tax structures.

The new rules limit the deduction of any taxpayer for net business interest expense to 30% of the taxpayer's adjusted taxable income for that year. This limitation would apply to all taxpayers, regardless of their form and regardless of whether interest is paid to related or unrelated parties in the US or abroad.

SFBT: Should businesses with international operations otherwise consider changes to their operating models or supply chains based on the new tax law changes?

Salinas: It depends on their current structures and how intercompany operations might currently be arranged, to really see how the new tax laws would impact those companies. However, there are other non-tax considerations companies have when operating in different countries. There are benefits a particular country might offer for investments, such as tax credits for investment in a certain industry. However, there are other non-tax considerations companies have when operating in different countries. There are incentives a particular country might offer for investments, such as tax credits for investment in a certain industry, or the possibility of a lower cost of labor in the local country or a lower currency value compared to the US dollar. Considering those factors, it is not simply the potential tax consequences a business would consider in making those determinations.

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SFBT: What is IC-DISC and how has the tax overhaul affected this tax program?

Salinas: IC-DISC is an export incentive regime within the US tax rules. The acronym itself refers to “interest charge domestic international sales corporation.” What it means is that there is potentially a significant tax savings for US persons who, for example, have products that are grown or manufactured in the US and then sold for consumption outside the US. The benefits could also apply to an architectural firm that is designing a building to be constructed in Germany, but the planning is being done in the US. Other examples would include software development carried out in the US for a foreign market or a film made in the US for overseas distribution. That firm would still qualify for the benefits of an IC-DISC.

To get the benefits, the US person would set up an IC-DISC, which is a separate entity that makes an election to be treated as an IC-DISC. The benefit that already existed before the Tax Cuts and Jobs Act was that the owner of a flow-through entity such as an S corporation or partnership could make an export sale through the IC-DISC. Because the IC-DISC is not subject to US tax, the IC-DISC tax savings to business owners are achieved from the reduced US tax rate on capital gains on at least half of the income derived from U.S. exported products, in lieu of the new Federal tax rate of up to 37% for individuals. Once distributed to the shareholder, the shareholder could take advantage of the capital gains rate of 23.8 percent tax on the profits of the IC-DISC that were not subject to US tax, thanks to the beneficial regime. So under the prior laws, export income of the IC-DISC benefitted from not being subject to the 35 percent corporate tax. Those rules are still in place, and the IC-DISC is still not subject to income tax. However, at the shareholder level, the benefit is slightly reduced. Previously at the shareholder level, there was a 15.8 percent tax savings considering the top marginal tax rate for individuals of 39.6 percent against the 23.8 capital gains tax rate applicable to dividend distributions paid out by the IC-DISC. Now the benefit is 13.2 percent, considering the highest marginal tax rate of 37% against the 23.8 capital gains rate. Of course, the difference between 13.2 and 15.8 is not insignificant depending on the export sales a business has, and there is still a meaningful tax benefit to establishing an IC-DISC for those businesses that qualify.

SFBT: How does the IRS look at these IC-DISCs?

Salinas: The IC-DISC is a long-standing export incentive under the US tax rules that is recognized and respected by the IRS if structured properly. At BPM, we have one of the largest IC-DISC practices in the country, with over 500 clients. We have not had significant challenges at all to the IC-DISC structures put in place. These structures are established in a way consistent with the relevant statutory and regulatory requirements, and BPM’s sophisticated practice analyzes the relevant facts related to a business’s qualified exports, and structures and reports for compliance purposes in a defensible manner. Without this level of careful planning and analysis, the IC-DISC arrangement could be subject to more scrutiny like any other cross-border transaction.

For additional information or to discuss any of the topics presented in this article, please contact Javier Salinas, Managing Director, International Tax Services, at (415) 288-6291. Learn more about BPM’s full range of International Tax and Transfer Pricing services by clicking here.

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