Across the pond

Ben Jones and Brendan Moran discuss the impact of US tax reform on UK companies.


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The US federal tax system is undergoing the largest and most significant reform in more than 30 years. The Tax Cuts and Jobs Act (TCJA), which was signed into law on 22 December 2017, introduced sweeping and fundamental changes. The details and application of these are still being developed through a stream of lengthy regulations and guidance flowing from the US tax authorities almost daily.

Given the importance of the US economy and, in particular, the links between the UK and the US, many businesses here will be affected, directly or indirectly. This is because either they have operations in or sell to the US, or they are owned by or supply to the US.

Key reforms for UK corporates

The reforms are wide ranging, and many are purely domestic in application. But others have more obvious cross-border implications, in particular:

- the reduction in the US federal corporate tax rate;
- the dividend participation exemption;
- the transition tax;
- global intangible low taxed income (GILTI) and foreign derived intangible income (FDII); and
- the base erosion anti-abuse tax (BEAT).

Reduction in federal corporate tax rate

Before the TCJA reforms, the US corporate tax rate of 35% was one of the highest headline rates in the world, even before state income tax was applied. Further, for US companies operating internationally, the US applied a worldwide system of taxation that imposed domestic corporate tax on foreign profits distributed to the US. Importantly, however, it was possible to defer US taxation on foreign profits by retaining these profits overseas.

Key points

- Before the reforms, the US had one of the highest headline rates of corporate tax in the world.
- Mandatory one-off transition tax has been introduced for undistributed earnings and profits of some controlled foreign corporations.
- New taxes ensure income is subject to the same rate US tax whether it is earned inside or outside the country.
- The base erosion anti-abuse tax is to discourage US companies using foreign affiliates.

This system resulted in a reported $2.6trn of foreign profits untaxed for US purposes and retained by US companies externally. It acted as an incentive for the businesses to invest elsewhere and structure their operations to maximise the generation of profits outside the US.

Most of the reforms discussed here are intended to make the US a more competitive jurisdiction internationally from a tax perspective. The most headline-grabbing of these is the reduction of the US federal corporate income rate from 35% to 21%. On paper, this is a significant cut, which brings the US corporate income tax rate more in line with other Organisation for Economic Co-operation and Development (OECD) members.

Benefits of change

For UK businesses with operations in the US, this change is beneficial because it should reduce the cost of business there and increase profitability. This could also support and justify expansion of American operations by UK businesses. For UK businesses owned by US companies, the impact of this rate reduction has to be considered with all the other reforms but could support a reallocation of future investment from the UK back to the US.

However, it is instructive to look behind the headline rate change to the actual effective tax rates likely to be payable. When factoring in state income tax rates, which vary considerably, it has been estimated that the average effective US corporate tax rate will be closer to 25%. Internationally, this still leaves the US at the higher end of effective corporate tax rates, and the UK, at 19% and falling to 17% in 2020, still compares favourably. Further, under the US tax system before reform, the availability of deductions and reliefs allowed many US corporates to achieve effective corporate tax rates of about 25%. It is therefore possible that the rate change alone will have little impact on cross-border investment decision-making and structuring by US-parented multinationals.

Dividend participation exemption

Another feature of the reform is an intended shift from a worldwide system of taxation to a territorial one through the introduction of a participation exemption for dividends. Under this, dividends of foreign profits from foreign corporations in which a US corporate shareholder has held a 10% or more voting or value participation for at least 365 consecutive days during a designated holding period will not be subject to US federal corporate tax.

There is much detail that limits the scope of this exemption, and it is not coupled with an equivalent one for capital gains or foreign branch profits, but this is also a positive step that better aligns the US with the territorial tax systems of most other jurisdictions. However, this move to territoriality is somewhat undermined by the other reforms discussed below.

For UK businesses, this is relevant only to those with US shareholders, and the main practical effect is likely to be that US parents may want excess profits distributed rather than retained by the US operation.

Transition tax

In the absence of the transition tax, the dividend participation exemption would allow a significant proportion of the historic profits rolled up in another country and on which US tax has so far been deferred to be repatriated tax-free and thereby escape US taxation completely.

Therefore, in connection with the introduction of the participation exemption, a mandatory one-time transition tax has been imposed on, broadly, the undistributed earnings and profits of controlled foreign corporations in which US shareholders hold more than 10%. This applies irrespective of whether amounts are repatriated to the US and is charged on US corporates at an effective rate of 15.5% for cash/liquid assets and 8% otherwise.

As a one-off tax event, this change will have limited impact in the long term but, in the short term, UK businesses controlled by a US parent may be asked to repatriate rolled up historic profits that have been subject to this transition tax. This is not solely a US tax issue because the UK tax and legal implications of any such repatriation need to be considered, such as the manner of repatriation, distributable profits restrictions, and potential withholding tax implications. Further, such rolled-up profits may be held by subsidiaries of UK companies in other jurisdictions, requiring analysis of the implications of repatriation. These issues are driving some corporate reorganisation activity as groups seek to repatriate profits to the US.

GILTI and FDII

It is on the tax rules governing global intangible low taxed income (GILTI) and foreign derived intangible income (FDII) that US tax reform starts to move into more uncharted territory.

They seek to tax and relieve the same type of income with the intended result that this income is subject to the same rate of US tax whether earned in the US or outside. In effect, it constitutes the imposition of a global minimum US tax charge on this income wherever earned and is principally targeting low-tax jurisdictions through the GILTI provisions. The FDII provisions apply the same minimum tax to equivalent income earned in the US from exploitation outside the US so that the higher base rate of federal corporate tax does not continue to act as an incentive to generate this income outside of the US in lower-tax jurisdictions. Although the GILTI provisions set a minimum rate of tax, this is lower than the headline federal corporate tax rate.

Income targeted

As the names suggest, the target of these rules is income derived from intangible assets. This income is targeted because intangible assets are mobile, can have significant value and can generate significant income. Historically, this has led to them being held or developed in lower-tax jurisdictions rather than in the US for tax-efficiency purposes.

However, due to perceived difficulties identifying income attributable to specific intangible assets, a formulaic approach has been taken to identifying relevant income. In effect, intangible income for the purposes of these provisions is all income earned by relevant non-US entities or from non-US sources above a specified (10%) return on the value of the tangible assets used to produce the income. Note, this is a broad simplification of detailed computational rules.

This formulaic approach results in the GILTI and FDII provisions being potentially applicable to a significant proportion of the non-US derived income of a US-based multinational business (whether directly attributable to intangibles or not).

GILTI

The GILTI provisions apply to the foreign active income of controlled foreign companies (CFCs) of US taxpayers (foreign income that has not been subject to US tax under other provisions). The tax on GILTI is levied directly against the US shareholder regardless of whether relevant profits are repatriated to the US or retained by the CFC.

The effective rate of tax on GILTI is 10.5% (50% of the headline 21% corporate tax rate). Foreign tax credits (FTCs) are then available to US corporate shareholders for any foreign tax paid on the same income, but these are restricted to 80% of non-US taxes paid. Therefore, for US corporates able to fully use FTCs, GILTI will be subject to US tax only if the effective rate of non-US tax on GILTI income is less than 13.125%.

The minimum rate of tax applicable to GILTI is set to increase to 13.125% from 2025, which will accordingly increase the minimum effective rate of non-US tax required to offset fully US tax on GILTI to 16.4%.

For UK businesses that are CFCs (for US tax purposes) of US companies, GILTI should not be an issue. The UK corporate tax rate should mean that enough FTCs are available to offset fully any GILTI charge for the US shareholder. However, there is a lot of uncertainty about the detailed application and calculation of GILTI as US Treasury regulations continue to be developed. In particular, it is unclear how FTCs are applied to GILTI in practice and there is concern that restrictions on them could result in double taxation. These issues are being monitored by US businesses and may require restructuring if problems arise.

Finally, although further away, it should be noted that the 2026 increase in the GILTI rate and the planned 2020 reduction in the UK corporation tax rate to 17% would make it more likely that the GILTI income of a UK CFC could be subject to US tax. However, much could change in the interim.

FDII

The FDII provisions apply to the income generated by US tax resident corporations from goods or services provided to any person outside the US. This FDII, determined through complex calculations and being excess income above a 10% return on applicable tangible assets, is subject to a reduced effective rate of US federal corporate income tax of 13.125%.

Hypothetically, since the same US tax rate (13.125%) should apply to intangible income wherever it is held, this should remove the US tax motivations to locate intangible assets in low-tax jurisdictions. Of course, this assumes that in practice the two regimes work as expected. If, for example, there are issues with FTC recognition for GILTI purposes that result in a higher GILTI tax rate, the FDII could act as an incentive to move intangibles to the US. This incentive exists in any event when the non-US tax applied to FDII exceeds the US FDII 13.125% tax rate.

In these circumstances, US corporations should consider whether it could be beneficial to transfer intangibles and other assets to the US from non-US entities (including UK entities) to access the FDII tax rate. The non-UK tax and other implications of any such transfer would need to be considered, together with any knock-on GILTI or BEAT implications (see the next section).

Finally, note that, in alignment with GILTI, the effective rate of tax for FDII is planned to increase to 16.4% in 2026.

Base erosion anti-abuse tax

The base erosion anti-abuse tax (BEAT) is another of the more unusual provisions in the reforms. In effect, it is an alternative minimum tax that is intended to disincentivise corporations from stripping earnings from the US through payments to foreign affiliates.

It works by adding back specified US tax deductible payments – such as interest expenses, royalty payments and management charges – made to foreign-related parties resulting in a higher net profit for BEAT purposes. The tax is then applied to these net profits at the rate of 5% for 2018, rising to 10% in 2019 and 12.5% from 2026. If, after this calculation, the BEAT payable exceeds the taxpayer's regular tax liability, this excess is payable by the taxpayer too.

On top of the alternative minimum tax effect, the BEAT causes problems because no account is taken of the fact that the relevant deductible payments may have been transfer-priced and, worse still, no FTCs will be available on any foreign tax paid in the related party jurisdiction. So, when the BEAT applies there is a material likelihood of double taxation. For example, if a UK company is the related party to an interest payment added back for BEAT purposes, there would be UK tax of 19% on such interest and also potential BEAT due to the add-back in the US.

It should be noted that the scope of the BEAT is restricted to larger multinationals (for it to apply, a US corporation must have average annual US gross receipts in excess of $500m). In addition, a de minimis level of related party payments will not trigger it. The tax will not apply when the proportion of base eroding payments does not exceed 3% of the corporation's annual deductible payments.

For UK businesses within its scope, it will be relevant to both US subsidiaries and US parent companies if related party payments are made from the US. When the BEAT applies, it will be necessary to consider whether applicable payments can be restructured. For example, there is an exclusion from the BEAT add-back for payments to related parties representing cost of goods sold. Historically, it might have been preferable to separately charge for the use of intangibles associated with goods sold intra-group. But, under the BEAT rules, it may now be preferable to re-incorporate this intangibles charge within the price of the goods.

Like other aspects of tax reforms, the detailed regulations in relation to BEAT are not yet available and so the full scope and application of this tax is not yet known.

Planning point

Clients with US operations or a US parent should be aware of the reforms to US tax. Remember to consider these when dealing with such companies and to keep an eye on future changes.

Looking forward

There is still much uncertainty about the scope and application of many aspects of US tax reform. As well as the lack of detailed guidance, there is also the threat of a challenge from the OECD or World Trade Organisation to various aspects of the reforms – FDII and BEAT in particular – as well as the possibility of political change in the US that may affect the process. What is certain is that US tax reform will inevitably have implications for UK businesses and needs to be considered by UK businesses with US operations or a US parent. ●

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