APTIOS
Solving The Global Tax Puzzle

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Report addresses TCJA impact on international corporate tax rules

The Congressional Research Service recently issued a report that looks at how changes made by the Tax Cuts and Jobs Act of 2017 (TCJA) to international corporate tax rules addressed concerns under previous tax law. The report also points out problems, issues and legal uncertainties that have arisen under the TCJA. Here’s an overview and some highlights of the findings.

Structure and general conclusions

The report is divided into three sections. The first section explains previous international tax rules and the revisions made in the TCJA. The second section discusses the four major issues of concern under previous law:

1. Allocation of investment,
2. Profit shifting,
3. Repatriation, and
4. Inversions.

In addition, the second section discusses how the TCJA addresses these concerns and raises new ones. It also discusses issues associated with international agreements. The third section summarizes commentary about problems and issues — including legal challenges and uncertainty within the new international tax regime and options that have been suggested.

The report says that one of the major motivations for the TCJA was concern about the international tax system. Issues associated with these rules involved:

- Allocation of investments between the United States and other countries,
- Loss of revenue because of the artificial shifting of profit out of the United States by multinational firms (both U.S. and foreign),
- Penalties for repatriating income earned by foreign subsidiaries that led to the accumulation of deferred earnings abroad, and
- Inversions (U.S. firms shifting their headquarters to other countries for tax reasons).

The report concluded that, in addition to lowering the corporate tax rate from 35% to 21% and providing other benefits for domestic investment (such as temporary expensing of equipment), the TCJA also substantially changed the international tax regime.

Shift to territorial system

The TCJA moved the tax system from a nominal worldwide tax on all foreign-source income, with a credit against U.S. tax for foreign taxes due, to a nominal territorial system that doesn’t tax foreign-source income. Nevertheless, the report says, both systems could be considered a hybrid of a worldwide and territorial system.

Previous law reduced the tax on foreign-source income by allowing:

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- Deferral (taxing income of foreign subsidiaries only if it was repatriated or paid as a dividend to the U.S. parent), and
- Cross-crediting of foreign taxes (so the credit for high taxes paid in one country could offset U.S. tax on income from a low-tax country).

The new system exempts dividends but also imposes a current worldwide tax on global intangible low-taxed income (GILTI), although at a lower rate.

It also introduces a corresponding lower rate on intangible income derived from abroad from assets in the United States — foreign-derived intangible income (FDII). The TCJA adds the base erosion and anti-abuse tax (BEAT) to existing anti-abuse measures aimed at artificial profit shifting. BEAT imposes a minimum tax on ordinary income plus certain payments to related foreign companies.

Whether capital will be shifted to the United States

The report says that, despite the lower corporate tax rate, it's unclear that capital will be shifted into the United States from abroad. Although a lower rate reduces the tax rate on equity-financed investments, it decreases the subsidy to debt-financed investments.

Whether equity investments increase or decrease depends on the magnitude of the TCJA (which appears largely offsetting) and the international mobility of debt vs. equity. It's also unclear whether the investment in stock will be allocated more efficiently or in a way more optimal for U.S. welfare, though economic theory suggests that reducing the tax subsidy for debt is a clear improvement.

Profit shifting less important

The TCJA's territorial tax may make profit shifting more attractive. But, overall, given other elements of the new system, the report says it appears to make profit shifting less important. GILTI and FDII bring the tax treatment of income from intangibles in the United States and abroad closer together. And BEAT and stricter thin capitalization rules (rules limiting interest deductions) also limit profit shifting, including shifting through leveraging.

In addition, the TCJA ends most "penalties" for repatriating earnings and thus eliminates the previous incentives to retain earnings abroad. As part of ending these penalties, the TCJA also introduced a series of measures aimed at making inversions less attractive.

Evolving effects

The report says some TCJA measures may violate international agreements such as those with the World Trade Organization, bilateral tax treaties and Organization for Economic Co-operation and Development minimum standards to prevent harmful tax practices. This and the other effects noted in the report will continue to evolve and undergo discussion, and we may even see further guidance. Work with your CPA to stay up to date on the latest developments. •