THE NATIONAL LAW REVIEW

US Tax Reform Implications from a Chinese Perspective

Wednesday, March 14, 2018

Summary

The recent US tax reform act carries potential ramifications for bilateral investment between the United States and China. We take a closer look at how tax reform might affect US multinationals operating in China, Chinese outbound investment into the United States, and high net worth Chinese individuals living in the United States.

This On the Subject includes contributions from Robbie H.R. Chen from MWE China Law Offices.

Article By Sandra P. McGill
David G. Noren McDermott Will & Emery
+Insights

In Depth

The Chinese and US economies, the two largest in the world, are highly integrated. Bilateral direct investment between the two countries exceeded $60 billion in 2016, reaching its highest level in history. Any change to one country's tax regime has a ripple effect on the other.

Even before President Trump signed the Tax Cuts and Jobs Act (Tax Act), many in China were monitoring the development of US tax reform. This article discusses the potential implications of the Tax Act from a US-China perspective, in particular its impact on US multinational corporations (MNCs) operating in China, Chinese outbound investment into the United States, and Chinese individuals living in the United States.

Impact on US Investment into China

Because the Tax Act may affect US investment into China in many ways, MNCs might reassess their current investment structure, repatriation planning and transfer pricing policies. The following considerations may be relevant to such a reassessment:

- While the Tax Act lowers the federal income tax rate from 35 percent to 21 percent, this reduction does not necessarily create a clear tax advantage that would cause a US MNC to consider relocating its existing subsidiaries in China back to the United States. The 21 percent rate is lower than China's 25 percent corporate income tax (CIT) rate, but after factoring in additional state and local taxes, the overall US tax rate is not particularly advantageous compared to China's. Additionally, China's vast market, complete industry chains, educated labor force and fast-developing infrastructure are benefits to establishment in China. As a result, US MNCs with investments in China—especially those with large manufacturing operations—may not find it worthwhile to relocate entities or activities based solely on recent US tax developments.
- US MNCs may consider simplifying their investment holding structure from the United States to China. For a long time, US MNCs have been using structures such as US-BVI/Cayman-Dutch/UK-HK-PRC for China investment purposes, to facilitate the deferral of US tax under a system that made it costly to repatriate foreign earnings. With the newly established territorial tax system for foreign dividends, it may be time to reconsider the necessity of such complex holding structures. Given China's scrutiny on the beneficial ownership status of the dividend recipient, it may not be easy to maintain multiple holding structures for purposes of exploring tax treaty benefits. Instead, US investors into China might consider a simple holding structure, such as US-China, decreasing the need for complex global business structures.

- The mandatory “repatriation taxes” under the Tax Act may not spur the actual distribution of retained earnings of a US MNC’s Chinese subsidiary. Dividend repatriation from Chinese subsidiaries is not easy, and is scrutinized and reviewed by the Chinese tax and foreign exchange authorities. A Chinese subsidiary must be profitable in order to distribute dividends under the Chinese Company Law. Such distribution can only occur once per year after the CIT clearance and the payment of withholding tax. In addition, the retroactive application of the “repatriation tax” may not provide any new incentive for US investors to repatriate their profits from China, as such profits have already been subject to the 25 percent CIT in China. These profits generally would not have been taxed again in the United States even if the United States still taxed dividend repatriations under a deferral.
- The new rules on global intangible low-taxed income (GILTI) and base erosion and anti-abuse tax (BEAT) may cause more cross-border tax disputes with China and other countries. The GILTI imposes a tax on the excess income of foreign subsidiaries over a 10 percent routine return on tangible business assets. This would cause an overlap with China’s policy encouraging MNCs to place their intellectual property rights in China by offering generous tax preferential treatments. Both the United States and China could claim taxation rights over excess profits generated by intellectual property rights, causing double taxation of the MNC. The new BEAT effectively would disallow the deduction of payments to foreign affiliates if such payments were considered to erode the US tax base. It would also create double taxation for the MNC, since such payments are usually treated as taxable income for the foreign recipient.

Impact on China Outbound Investment into the United States

The reduction of the headline tax rate and the repeal of the corporate alternative minimum tax (AMT) is good news for Chinese investors with a US subsidiary. Additionally, the tax reduction in the United States may help US companies achieve a higher profit margin in the future.

Here are a few issues that Chinese entities investing in the United States should consider:

- Dividend repatriation from the United States to China is still subject to Chinese CIT (China’s CIT is still a global tax system), but the US federal income tax can be credited against Chinese CIT liabilities. When the US federal income tax rate was 35 percent, compared to the Chinese CIT rate of 25 percent, this was not an issue. But now, with the 21 percent headline corporate tax rate in the United States, Chinese investors should consider whether it makes sense to defer repatriation to China.
- The interest deduction rules may affect an investor’s choice of equity versus debt financing model for its US subsidiary. There would be an upper cap for US enterprises to deduct business interest expenses after January 1, 2018, applicable to both related and non-related party loans. The new rule not only expands the limitation on business interest expense deductions to both related and non-related party loans, but also lowers the upper deduction limit. Obviously the goal of a stricter limitation is to encourage investment into the United States in the form of equity rather than debt. Taking into account the stricter limitation policy and comparisons of term, exit and amount between debt investment and equity investment, Chinese investors may consider and balance the portion of debt investment to equity investment.
- The Tax Act will also affect the way investors acquire US businesses. The Tax Act allows 100 percent expensing for property placed in service between September 27, 2017, and January 1, 2023. Additionally, the expensing portion would be phased down by 20 percent a year after December 31, 2022, and again before January 1, 2028. While the goal of this cost recovery regime is to encourage updating infrastructure and outdated equipment, as well as the facilitation of fixed asset investment, a potential buyer of a US business may also take advantage of the rule. Instead of buying the US target company, the potential buyer may instead buy the assets from the target company and enjoy the full expensing of the acquisition in the current period.
- Chinese manufacturers may try to benefit from the foreign-derived intangible income (FDII) rule under the Tax Act. The FDII rule encourages manufacturers to establish their presence in the United States and rewards US manufacturers for excess returns earned from overseas sales by allowing a reduction of the headline tax rate for the excess part of the return. The FDII effective rate could lower the headline corporate tax rate to around 13 percent. This is significantly lower than the 25 percent CIT rate in China and may be appealing to large Chinese manufacturers. Some Chinese manufacturers, such as Fuyao Glass (an automobile glass manufacturer), have already moved or are considering moving factories to the United States.
- Chinese investors may need to consider the potential Controlled Foreign Company (CFC) implications under the China CIT. The United States is traditionally a white-listed country for Chinese CFC purposes. However, the slashed headline tax rate under the Tax Act may cause the State Administration of Taxation (SAT) to reconsider its current position. Under Chinese CFC rules, if the “effective tax rate” of a foreign subsidiary of a Chinese company is lower than 12.5 percent, then that foreign subsidiary could potentially be treated as a CFC of the Chinese investor. If that is the case, then the profits of the CFC would be deemed to have been distributed to the investor and be subject to CIT in China. Although 21 percent is still obviously higher than 12.5 percent, it will be interesting to see how the SAT will interpret the “effective tax

rate" and what US subsidiaries' "effective tax rate" will be, considering the preferential policies under the Tax Act.

Impact on Chinese High Net Worth Individuals (HNWIs)

As of January 1, 2017, the number of families in China with net assets of more than RMB 10 million (approximately $1.57 million) had reached 1.86 million, with 147,000 added in 2016 and a growth rate of 8.6 percent. Families with net assets of more than RMB 100 million ($15.7 million) has reached 121,000, with 12,000 added in 2016.

For Chinese HNWIs with an "American dream," the Tax Act may have profound implications.

Buying US Real Estate

Buying US property is often the first thing Chinese HNWI immigrants consider, even before moving to the United States. For Chinese HNWIs who are inclined to invest in real estate for investment purposes or to purchase a house in the United States for personal use, the taxation cost could increase under the Tax Act. Pursuant to the Tax Act, the loan principal limit on the mortgage interest deduction for newly purchased houses after 2018 decreased from $1 million to $750,000. The interest deduction on home equity loans also has been repealed, which seems to be bad news for property buyers. Of course, this would not directly affect those who buy real estate without using a mortgage.

Marriage and Inheritance Planning

For Chinese HNWI immigrants, the increased exclusion of estate/gift tax is good news. Compared with Chinese laws, US law offers more flexible and tax-efficient options for pre-marriage and inheritance planning. The US trust regime and the corresponding tax rules could be a valuable tool for Chinese HNWIs. For example, a US trust could be considered for HNWIs with assets such as jewelry, antiques and crafts that are difficult to evaluate and put under a Chinese trust.

Interplay Between the US and Chinese Tax Policies

There is no doubt that the US tax reform aims to stimulate the return of US capital and business. Although the SAT has repeatedly stated that it will not engage in a tax cut competition with the United States, China has nonetheless been making preparations to lower the overall tax burden of Chinese companies on multiple fronts. MNCs will be glad to see the two countries competing to retain businesses by improving the business environment.

Lower CIT Rate in Certain Industries

In recent years, the Chinese government has been gradually extending lower a CIT rate in certain industries. Pursuant to Caishui [2017] No. 79 issued on November 2, 2017, qualified technology advance service enterprises (TASEs) nationwide engaging in service outsourcing businesses can enjoy a 15 percent CIT rate as opposed to the 25 percent statutory rate.

Qualifying enterprises located in western China also enjoy a 15 percent CIT rate between January 1, 2011, and December 31, 2020. As a supplementary policy, enterprises engaged in transportation, electricity, water conservancy, postal services, and radio and television services that are newly established in western China prior to December 31, 2010, and which currently enjoy the preferential policy of CIT "two-year exemption and three-year half-rate levy," may continue to enjoy such a policy until that term expires.

Various types of national tax preferential policies would bring the effective tax rate of Chinese companies below 25 percent. This would make the 21 percent US federal income tax rate less appealing, particularly when considering relocation costs and significant cultural differences.

China likely will maintain its flexibility to keep its low tax rate advantage in certain industries compared to the United States, possibly attracting more multinationals (including US multinationals) to transfer design, R&D, procurement and management-related business and functions to China.

Tax Deferral Policy on Reinvestment

The withholding tax deferral policy (Caishui [2017] No. 88) issued on December 21, 2017, may be an effective solution to counter any potential capital flight caused by US tax reform. Foreign investors may enjoy the deferral of the withholding tax on dividend distribution if such dividends are reinvested directly into "encouraged" projects in China, and if the funds are directly transferred to the invested projects from the dividend distributing entity without leaving China.

Value-Added Tax (VAT) Reform

In addition to the CIT incentives, the VAT reform implemented in China has resulted in a major tax reduction. The VAT covers all sales of goods, provision of services, and transfer of immovable and intangible assets.

In 2012, the Chinese government began partially carrying out VAT reform, which was rolled out on May 1, 2016. It has since been completed. As a result of the VAT reform, the business tax has been comprehensively replaced, and the VAT has been applicable to all significant fields, including real estate, construction, financial services and lifestyle services. The SAT confirmed that the 2017 tax reductions totaled roughly RMB 918.6 billion ($141.32 billion) and should materially boost Chinese enterprises' profitability. The generated tax relief is expected to flow back into businesses and benefit China's economy.

Similar Anti-Avoidance Rules in China

As noted above, the US tax reform adds a BEAT rule that imposes additional taxes on enterprises making certain kinds of deductible payments to overseas related parties, and effectively restricts the benefits of deducting those payments. The BEAT is an aggressive anti-tax-avoidance measure, but it is not entirely without precedent.

Similar rules were applied in China around 2014, prohibiting the pre-tax deduction of expenses paid to overseas parties that fail to perform sufficient functions and bear risks. China's tax arsenal also has the very controversial indirect transfer rule to counter tax avoidance on corporate transactions.

Conclusion

The recent US tax reform legislation represents the most radical change to the US tax system in decades and will have spillover effects on businesses and individuals around the world that have nexus to the United States. This round of tax competition led by the United States may not necessarily cause adverse effects in China, despite concerns that large manufacturers might consider relocating their factories to the United States. Because of the interplay with China's tax policies, the overall impact on China will likely be moderate, but all taxpayers will want to carefully evaluate this interplay under these new circumstances.

Source URL: https://www.natlawreview.com/article/us-tax-reform-implications-chinese-perspective