US corporate income tax rate may affect taxation of non-US CFCs operating in the United States

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In brief

The US 2017 tax reform Act (the Act) continues to have a substantial impact on multinational companies, whether headquartered in the United States or elsewhere. In some instances, the provisions of the Act are causing unintended consequences for non-US headquartered companies (US inbound companies) as they interact with provisions of their home countries' tax laws. Even a positive aspect of US tax reform – such as the reduction of the corporate income tax rate – may negatively impact certain business operations of US inbound companies.

Specifically, some countries have laws similar to the US laws governing controlled foreign corporations (CFCs), which may require companies to pay tax in their home country on income earned from CFCs located in low-tax jurisdictions. With the lower US corporate income tax rate and the 'foreign-derived intangible income' (FDII) rate, some countries' tax laws possibly may view the United States as a low-tax jurisdiction. This Insight offers some examples illustrating this potential issue.

In detail

The Act lowered the US corporate income tax rate to 21% from 35%. It also created a new provision in Section 250(a), known as foreign-derived intangible income (FDII), which provides a deduction for US domestic corporations that engage in certain export activities. The FDII provision will result in an effective US federal income tax rate of 13.125% on certain income in tax years beginning after December 31, 2017 and on or before December 31, 2025, and 16.406% on FDII in tax years beginning after that date.

The new corporate income tax rate and the FDII rate may result in some countries' tax laws classifying the United States as a low-tax jurisdiction. Consequently, this may impact how income earned by a US subsidiary of a multinational corporation is taxed in its home country. This Insight uses the term 'CFC' for consistency instead of a country's native name to describe generally a corporation operating in the United States and controlled by shareholders from its home jurisdiction.

Germany

Provisions of Germany's Foreign Tax Act addressing CFC taxation generally provide that certain low-taxed passive income generated by a CFC deemed an 'intermediate company' will be subject to German taxation at the German shareholder level. To be considered a German CFC, German taxpayers must own, directly or indirectly, more than 50% of the shares or voting rights at the end of the CFC's financial year.

Where the CFC earns certain types of passive investment income, the ownership threshold is either 1% or does not apply.

An 'intermediate company' is defined by the Foreign Tax Act as a foreign corporation which:

(1) has neither its place of management nor its registered office in Germany,

(2) receives income from certain 'passive business activities,' and

(3) is subject to an effective taxation of less than 25% on its passive income in the foreign country (determined by German rules).

Passive income is defined as income that is not listed as active in the Foreign Tax Act. Active income generally includes income from agriculture, production and manufacturing, banking or insurance, trading, services, leaving and licensing of assets, profit distributions of corporations, and certain lending. Various exceptions need to be taken into consideration requiring a case-by-case analysis.

With the new US corporate income tax rate of 21% effective for tax years beginning on or after December 31, 2017, German CFCs deemed 'intermediate companies' may trigger German taxation at the shareholder level if any applicable state and local taxes do not result in reaching the 25% low-taxation threshold.

Other provisions of the Act, however, may complicate this analysis. For example, a German CFC may be subject to the base erosion and anti-abuse tax (BEAT), which imposes a minimum tax on deductible related-party US payments to foreign entities at a 5% rate for tax years beginning in calendar year 2018, 10% for tax years beginning in 2019 through 2025, and 12.5% for tax years beginning after December 31, 2025. This would have the effect of increasing the CFC's tax rate and possibly increasing it above the 25% threshold.

Observation: Conversely, if a US subsidiary of a German company is entitled to the FDII deduction at the preferential effective tax rate of 13.125%, the subsidiary may see a reduction in its overall effective tax rate and be at risk for falling beneath the 25% threshold.

Japan

Under prior rules, a non-Japanese company was deemed a CFC if Japanese shareholders owned more than 50% of the company's outstanding shares, voting shares, or dividend rights and had an effective tax rate of less than 20%. Japan's CFC rules, however, were amended in 2017 and are applicable for fiscal years beginning on or after April 1, 2018. Under the new rules, a corporation will be deemed a CFC by either an 'equity ownership test' or a 'de facto control test' – whereby an entity will be considered a CFC if it is controlled 'in substance' by Japanese shareholders.

Income earned by a Japanese CFC under these new rules satisfying an economic activity test will not be subject to taxation regardless of the CFC's effective tax rate. This test generally requires that the company have some economic substance to its operation. Certain passive income may be subject to taxation if the effective rate is below 20%; however, there is a *de minimis* rule holding that passive income will not be taxable if the amount does not exceed JPY 20M or 5% of net income before taxes. The scope of what comprises passive income has expanded under the new Japanese CFC rules.

Income earned by a CFC that does not satisfy the economic activity test and that is subject to an effective tax rate of less than 20% will be subject to taxation under the new Japanese CFC rules. Because the new US corporate income tax rate is 21% and state taxation will likely apply, Japanese CFCs operating in the United States that do not satisfying the economic activity test may find that their income is not subject to taxation in Japan. If, however, a Japanese CFC is entitled to the deduction for FDII at the preferential effective tax rate of 13.125%, the CFC may see a reduction in its overall effective tax rate and be at risk for falling beneath the 20% threshold.

The new CFC rules also add three new CFC categories – a paper company, a cash box company, and a black list company. A paper company is one that generally has no fixed place of business and no separate management function. A CFC will be considered a cash box company if it meets both a passive income and asset test. A black list company is one located in a jurisdiction designated by the Minister of Finance of Japan as not cooperating in the exchange of tax information.

A CFC that qualifies as any one of these three companies and that is subject to an effective tax rate of less than 30% will be subject to the new Japanese CFC rules. Certain holding companies, limited liability companies that are interposed from a US tax perspective, or segregated portfolio companies may fall under the category of a paper company. The expected 2019 tax reform in Japan would amend and narrow the scope of paper companies to avoid unintentional taxation likely happening to CFCs in the United States.

Observation: Japanese companies with CFCs operating in the United

States that are considered paper or cash box companies may be below the 30% effective tax rate even when state tax rates are added to the federal corporate rate of 21%. Again, the determination may be made more complex if the CFC is subject to BEAT or FDII. Since the United States cooperates with Japan's Minister of Finance, no Japanese CFC operating in the US should be considered a black list company.

Mexico

Mexican subsidiaries operating abroad are subject to certain anti-deferral rules when their income is subject to a 'Preferential Tax Regime" (PTR). Income generally is subject to a PTR when it either is not taxed abroad or is taxed at a rate below 75% of the income tax rate to which it would be subject in Mexico. The Mexican corporate income tax rate is 30%; 75% of that rate is 22.5%. Income earned by a Mexican business operating in a lower-taxed jurisdiction where Mexican shareholders do not have control will not be deemed to be subject to a PTR.

While the US corporate income tax rate is below 22.5%, US state tax rates (which range from 0% to 9%) and, if applicable, the BEAT rate could increase the Mexican CFC's effective tax rate above the 22.5% rate. FDII, however, may have the effect of reducing the overall effective tax rate.

Observation: Adding to the complexity of this analysis is whether any state in which a CFC operates follows the federal BEAT and FDII provisions. Whether a state follows any of these federal provisions will impact the CFC's effective state tax rate which, in turn, will impact the CFC's overall US effective tax rate. US inbound companies should have a sound understanding of how to properly calculate their state income tax to help determine whether their CFC income generated in the United States is subject to taxation at the shareholder level in their home countries.

The takeaway

While the reduction in the US corporate income tax rate generally is considered beneficial, US inbound companies whose home jurisdictions' CFC rules are impacted, in part, by the effective tax rate paid in foreign jurisdictions, will need to analyze how the lower US rate may impact the overall US taxation of their US CFCs. These companies will need to evaluate how all the provisions of the Act impact their effective tax rate to determine whether any of their earnings may be included in the parent company's income or otherwise taxed in their home jurisdictions. These companies also should be aware that calculating various states' effective tax rates may be complex as some states adopt certain provisions of the Act while others do not.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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