

KEY POINTS

- The Tax Cuts and Jobs Act of 2017 is the first major tax reform in the US since 1986. Its potential spillover effects can reach far beyond the US, and could lead to (i) shifting of short- to medium-term capital, (ii) motivating other countries to reduce corporate tax rates, (iii) creating more demand for imports to the US as a result of stimulating the US economy through tax cuts, (iv) eroding the individual tax base of other countries, and (v) eroding corporate tax base of other countries.
- As corporate tax is already low in the PRC, the country should not join the tax competition. Instead, the PRC should continue to improve its business environment to attract foreign direct investment. On the individual tax front, the PRC should continue with efforts to broaden its tax base.

Tax Reform in the United States: Implications for the People's Republic of China

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The Tax Cuts and Jobs Act of 2017 is the first major tax reform in the United States (US) since 1986. Its potential spillover effects can reach far beyond the US borders. Possible channels through which the tax package can have spillover effects on other countries include (i) shifting of short- to medium-term capital, (ii) motivating other countries to reduce their corporate tax rates, (iii) creating more demand for imports to the US as a result of stimulating the US economy through tax cuts, (iv) eroding the individual tax base of other countries by attracting more wealthy migrants to the US, and (v) eroding the corporate tax base of other countries through profit shifting to avoid “foreign high returns” status. However, international experience suggests that the net impacts are uncertain and mixed. Policy implications for the People's Republic of China (PRC), however, seem to be clear. As the corporate tax rate is already low in the PRC, the country should not join in the tax competition. Instead, the PRC should continue to improve its business environment to attract foreign direct investment. On the individual tax front, the PRC should continue with efforts to broaden its tax base.

OVERVIEW OF THE TAX CUTS AND JOBS ACT OF 2017

On 22 December 2017, the Tax Cuts and Jobs Act of 2017 was signed into law after both the House of Representatives and the Senate voted to approve it. This tax reform bill was the first major tax reform in the US since 1986, with potential spillover effects reaching far beyond the US borders. This tax reform package makes fundamental changes to four major components in the US tax laws: individual income tax, corporate income tax, pass-through entities tax, and estate and gift tax. In addition, the Act aims to achieve four objectives:

- (i) simplify the tax code,
- (ii) give American workers a tax cut,

- (iii) create more jobs by leveling the playing field for American businesses, and
- (iv) bring back trillions of dollars that are currently kept offshore for reinvestment in the American economy.

Changes to Individual Income Tax Rates

For individuals, the new tax brackets are lower, with the highest rate at 37%:

- (i) Old rates (seven income tax brackets): 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.
- (ii) New rates (effective 1 January 2018; seven tax brackets): 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

Changes to Property Tax Deduction as Part of the “Itemized Deductions”

To simplify the tax code, the new law eliminates most of the “itemized deductions” that individuals could claim on their tax forms to reduce their federal income tax liability. In the US, property tax is assessed and collected by the local government where the property is located as a source of local revenue. The tax rate is determined by the local government each year based on its budgetary needs. A home owner whose house is valued at \$200,000 may pay between \$2,000 and \$4,000 yearly in property tax (1%–2%).

Depending on the property value and the tax rate (as determined by the local taxing authority), property tax could represent a big tax burden—but also a big tax break when used as part of the “itemized deductions” to reduce federal income tax. This is especially true for taxpayers who live in large metropolitan areas of the East Coast and West Coast where property value, and thus property tax, is very high.

The topic of property tax deduction, along with home loan interest deduction, has been hotly debated. In the end, the new tax law preserved the current property tax deduction, but it is capped at \$10,000.

Changes to Other Credits and Deductions

In lieu of a long list of “itemized deductions” under the prior law, the new law eliminates most of it and doubles the “standard deduction” that everyone can take. A single filer’s “standard deduction” increases from \$6,350 to \$12,000. The deduction for married and joint filers increases from \$12,700 to \$24,000. The new law eliminates “personal exemptions” and increases child credit from \$1,000 to \$2,000 per child. It is estimated that under the new law, only 10% of taxpayers “itemize” their deductions whereas more than 45% did before. This

change simplifies tax return preparation and audits, and thereby reduce the burden for taxpayers and in tax administration.

Changes to Estate and Gift Tax

The new law doubles the estate tax exclusion amount from \$5.6 million to \$11.2 million. The original proposal to repeal and eliminate estate tax did not pass. It was criticized as a provision to benefit the wealthiest. But from the viewpoint of tax administration, the repeal is not entirely without merit. The entire estate planning industry, which has grown over the years with stunning speed and sophistication, may be redirected to other more productive endeavors if there is no estate tax. Estate tax revenue is relatively small relative to its high administrative costs due to increasingly sophisticated schemes. It is undeniable, however, that the public perception is against its repeal. It is, therefore, not surprising that the estate tax repeal did not make it to the final bill.

Changes to Corporate and International Taxation

For corporations, the new law reduced the tax rate from 35% to 21%. When state and local corporate taxes are added (averaging 4%), the new corporate tax rate is about 25%, in line with that of most countries of the Organisation for Economic Co-operation and Development (OECD), and the same as the rate in the PRC. This corporate rate cut, together with other significant changes, will likely have a significant impact on multinational corporations.

The previous US corporate tax system had three drawbacks—that had resulted in base erosion and profit shifting—that needed to be fixed:

- (i) US corporations had tax incentives to keep their earnings overseas and not repatriate them back to the US for reinvestment.
- (ii) US corporations had tax incentives to locate production activities (jobs) overseas.
- (iii) US corporations had tax incentives to engage in profit shifting through transfer pricing and base erosion, often by transfer of intangible assets, to take advantage of lower tax rate jurisdictions.

The new tax law also calls for the adoption of a modified “territorial” tax system. It prescribes a “dividend exemption” system whereby dividends paid by a foreign subsidiary to a US corporate stockholder are tax-exempt. But the new law does impose tax on “high-return” foreign subsidiaries, i.e., when foreign earnings are above a “routine return.” In addition, businesses need to pay a “deemed repatriation” tax for their historic earnings that were untaxed from 1986 to 2017, whether they actually repatriate cash stockpiles or not. This provision intends to encourage companies to move cash back for investment in the US.

The plan also calls for limiting current deductions on interest expense to 30% of earnings before interest and tax. This would effectively remove (or at least decrease) the incentive for complex capital structure among related parties.

New Tax Deduction for “Pass-Through” Entities

The Tax Cuts and Jobs Act of 2017 also introduces a first-ever 20% deduction for “pass-through” entities such as sole proprietors, partnerships, and limited liability companies whose income is above \$315,000. This is a significant change, as over 90% of businesses in the US are structured as pass-through entities. Many professional service entities, however, are not eligible for this deduction. In addition, a certain percentage of the total income, depending on several factors, must be treated as wages to prevent abuse.

Finally, the new law eliminates the alternative minimum tax for corporations, and reduces it for individuals.

CHANNELS FOR SPILLOVERS AND IMPLICATIONS

The tax reform could have impacts through various channels, such as (i) shifting of short- to medium-term capital, (ii) motivating other countries to reduce their corporate tax rates, (iii) creating more demand for imports to the US as a result of stimulating the US economy through tax cuts, (iv) eroding the individual tax base of other countries by attracting more wealthy migrants to the US, and (v) eroding the corporate tax base of other countries through profit shifting to avoid the “high return” status.

Shifting of Short- to Medium-Term Capital

The one-time reduced tax rate to encourage US multinational companies to repatriate their stockpiled earnings could have significant spillover effects. So would the “deemed repatriation” provisions, also designed to move capital from abroad back to the US. These new provisions are intended to boost the US economy and create jobs. While estimates suggest that the magnitude of such outflows will be small relative to overall capital flows, the PRC should be aware of the potential for unexpected capital outbound movements due to the tax incentives offered by the US.

According to the US Bureau of Economic Analysis, affiliates of US firms that are based in the PRC held \$627 billion in assets at the end of 2015. However, most of the assets are integral parts of the businesses that will not be sold off in response to tax changes. Cash and cash equivalents make up just under 12% of US majority-owned affiliates’ assets in the PRC. Assuming that the same ratio applies to minority-owned affiliates, the “cash pile” held by US multinational companies operating in the PRC totaled \$72 billion at the end of 2015, and has probably risen to around \$100 billion by second half of 2017. About \$40 billion of this cash pile, or about 5% of total assets, will most probably be held as a cash buffer to meet daily operating needs. The remaining \$60 billion could potentially be distributed to the owners.

However, not all of this \$60 billion would be repatriated. A portion of this would flow to domestic stakeholders, as many US affiliates are

joint ventures with local firms. Indeed, almost 40% of the total assets of US affiliates based in the PRC are held by firms with majority Chinese ownership.

Finally, earnings that are retained overseas for tax purposes are often held in dollar-denominated assets in order to reduce exchange rate risk. Surveys suggest that this is the case for at least half of offshore US corporate funds. The repatriation of dollar-denominated assets would not affect the PRC balance of payments nor the exchange rate. Overall, the repatriation might lead to outflows from the PRC of at most \$20 billion in 2018, which is a small number in the PRC context where, in 2016, capital outflows were in the magnitude of \$585 billion.

As the estimated magnitude is small, urgent policy actions are neither expected nor encouraged. Multinational companies have, and would continue to use, low tax regimes as a platform for international tax planning. The US corporate tax reform intends to correct some of these abusive practices to some extent. OECD’s base erosion and profit shifting project recommends countries to work and counter harmful tax practices more effectively through compulsory spontaneous exchange on rulings related to preferential regimes. The PRC should continue to perfect and strengthen its anti-avoidance provisions, and continue to participate in the base erosion and profit shifting project to combat sophisticated schemes employed by large multinational companies.

Motivating Other Countries to Reduce their Corporate Tax Rates

The international tax cut race-to-the-bottom is not new. In the US, the proposed deduction in the corporate income tax rate is consistent with the recent global trend of reducing the corporate tax rate. In OECD countries, 21 out of 35 (or 60%) countries have reduced their corporate tax rate within the past decade, some quite significantly. Japan, South Africa, and the United Kingdom experienced a double-digit drop over the past 10 years. The US (39%), Brazil (34%), and France (34%) are the only countries that have maintained stable tax rates (Table 1).

International experience suggests that joining in the competition would not necessarily have desired effects such as generating more capital inflows, and boosting of the economy that can offset any negative impacts on tax revenue. There is no clear evidence of attracting significantly more foreign direct investment as a country cuts the corporate income tax. This is possibly due to other factors that corporations consider, such as skilled or specific type of labor force, proximity to the market, sunk and relocation costs, among others.

The PRC’s corporate tax rate is competitive at 25%, and many high technology and “encouraged” industries benefit from even lower rates. Together with its favorable investment environment such as plentiful labor force and large domestic market with rising income, the PRC has been and could continue receiving foreign direct investment inflows. In determining its strategies to combat tax competition, the PRC should examine its competitiveness and investment environment without cutting the already favorable tax rates any further.

Table 1: Combined Corporate Income Tax Rates
(%)

	2005	2017
United States	39	39
Brazil	34	34
France	35	34
Italy	37	31
Germany	39	30
India	37	30
Japan	40	30
South Africa	38	28
Canada	34	27
People's Republic of China	33	25
Republic of Korea	28	24
Russia	24	20
Viet Nam	28	20
United Kingdom	30	19
Singapore	20	17

Source: OECD, Trading Economics, government websites.

Creating More Demand for Imports

In the short run, some spillover effects can be expected through changes in tax revenues and government spending in the US. The tax reform could stimulate the US economy through tax cuts, boosting domestic demand for both domestic and imported goods. With the PRC being one of the major trading partners of the US, the higher demand for imports could mean more capital and consumer goods exports from the PRC to the US. This assumes a major escalation in trade conflict is avoided. On the other hand, if the US tax package increases budget deficits or leads to fiscal underspending, this could dampen the economic activities, including the demand for imports. It could also reduce capital spending, making the US less attractive to foreign investors. However, the evidence of short-run impacts is mixed at best, and the net effects are unclear. The experience of Japan and the United Kingdom, where the corporate tax rates have dropped significantly, show that the tax revenues do not necessarily drop proportionally to the cut in nominal corporate tax rate, for example.

Eroding Individual Tax Base of Other Countries by Attracting More Wealthy Migrants

Reforms on individual income tax are expected to have a limited impact on the PRC, but some speculate about spillover effects in the form of increased immigration to the US. This is particularly so for wealthy Chinese, after the US estate tax doubled its exemption to over \$11 million, and \$22 million for married couples. In this case, there

could be a base erosion of the individual income tax in the PRC. The issue can be critical as the individual income tax revenue is already low, accounting for less than 7% of the PRC's total tax revenues—which largely rely on the corporate income tax as well as goods and services in the country. This contrasts sharply to the case in the US, where the base erosion already took place on the corporate income tax. The corporate income tax accounts for only 9% of the total tax revenues (Table 2).

Although there is no clear evidence showing that tax incentives would serve as a strong motivation for immigration, the erosion in the individual tax base may become serious given the already narrow base in the PRC, and may affect the overall tax structure. The PRC could continue to reform personal income tax based on experience and good practice in other countries. One of the key areas for reforming the PRC's personal income tax appears to be broadening its tax base. Although the individual income tax rate in the PRC is broadly progressive, ranging from 3% to 45%, in practice, there are very few high-income earners in the top tax brackets. The recent upward adjustment of the bracket and the raise in the personal deduction amount from CNY 3,500 per month to CNY 5,000 are welcome steps.

Eroding Corporate Tax Base through Profit Shifting to Avoid “Foreign High Return” Status

Under the new US corporate law, a foreign subsidiary should pay tax in the US on 50% of their foreign-earned income if they meet the definition of having “high return.” Foreign high returns are measured as

the excess of the US parent’s foreign subsidiaries’ aggregate net income over a routine return (7% plus the federal short-term rate) on the foreign subsidiaries’ aggregate adjusted bases in depreciable tangible property. From the perspective of the US, this provision is designed to prevent shifting of income inappropriately to a foreign country to take advantage of the “territorial” tax system.

The same provision, however, could provide a tax incentive to shift income back to the US in order to avoid a “high return” tax. This could potentially erode the corporate tax base of the countries where the US companies operate. Considering the important role that corporate tax revenue plays in the PRC, attention should be paid to minimize inappropriate transfer pricing practices designed to ensure that there is no “high return” (Table 2).

Table 2: Tax Revenue by Component, 2016
(%)

	PIT	CIT	SSC	Prop ^a	GST ^b	Other	Total
United States	40	9	24	10	17	0	100
Germany	27	5	38	3	27	0	100
United Kingdom	27	8	19	12	33	1	100
France	19	5	37	9	24	6	100
Japan	19	12	39	8	21	1	100
People’s Republic of China ^c	7	22	–	16	53	2	100

– = not available, CIT = corporate income tax, GST = goods and services tax, PIT = personal income tax, Prop = property tax, SSC = social security contribution.

^a The Prop figure includes both property and “behavior” tax.

^b GST includes value-added tax, business tax, and excise tax.

^c SSC was not shown as a source of revenue in www.chinatax.gov.cn.*

Sources: OECD. 2017. *Revenue Statistics 1965–2016*. Paris: OECD Publishing; State Administration of Taxation of The People’s Republic of China. www.chinatax.gov.cn.*

* ADB recognizes “China” as the People’s Republic of China.

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