Long Island Business News

DOUGLAS NAKAJIMA: The United States is moving toward a territorial tax system, with a twist.

# Global gathering

By: Claude Solnik January 22, 2018

For many years, many U.S. multinational companies hoarded cash abroad. As long as they didn't bring money they earned abroad back to the United States, they wouldn't be taxed by the United States government.

The George W. Bush administration declared a tax holiday in 2004 and 2005 when money could be brought back at a reduced rate of 5.2 percent. About $362 billion flowed back home, resulting in about $18 billion in tax.

It appeared the waiting game was on again for the next holiday or next round of high-stakes hide (although it wasn't really hidden) and seek. But the Trump Administration rewrote the rules for taxing firms' subsidiaries abroad last month in what could be the biggest change in the nation's global tax code.

The new rules will result in hundreds of billions of dollars in taxes that must be paid on money already accumulated abroad.

But they also will let much of the money earned abroad in the future come back tax free (zero percent income taxes at the corporate level) with the remainder potentially taxed at a reduced rate, if it is classified as something known as "intangible income."

"You don't have an option relative to the earnings you parked in that offshore company," Douglas Nakajima, international tax co-leader for Marcum, said of money already accumulated abroad. "This is a mandatory repatriation of those earnings."

Cash and cash equivalents already abroad (and hitherto untaxed) will be taxed at an effective rate of 15.5 percent, below the typical corporate rate, and non-cash assets will be taxed at a rate of 8 percent.

"You're going to get taxed at that rate regardless of whether you bring it out of that foreign company into the U.S," Nakajima said. "At the very least companies are going to want to bring out enough cash to cover the tax liability."

This is going to result in hundreds of billions of dollars, or more, flowing back into the United States economy: the proverbial pot of gold at the end of the regulatory rainbow. It's likely to make the George W. Bush tax holiday seem like a weekend.

"That's an immediate cash inflow for the government and companies," said Raymond Haller, a tax partner at Jericho-based Grassi & Co. "That's a quick shot in the arm."

The new rules for money already accumulated abroad, however, don't call for voluntary repatriation as in the Bush tax holiday. You must pay taxes.

"They had a program that tried to give incentives to bring money into the U.S. People brought it back," Nakajima said of the Bush holiday. "Here there's no choice."

In the short term, this is going to mean billions for the federal government, whether to build bridges (or walls), pump into the general fund or otherwise bolster its balance sheet. And it could boost the economy, as companies bring money back home.

"If the repatriation works the way it's supposed to, there will be a lot of cash in the U.S.," Haller said. "Hopefully, it will lead to more expansion of U.S. businesses, hiring and investment in the U.S."

The multi-billion-dollar question, however, is where companies with operations abroad will put cash after they pay taxes.

"What are they going to do with it? Invest in infrastructure for the company in the U.S., comp out your employees?" Nakajima asked. "Some companies are passing bonuses through to employees. That's a possibility. The other is to buy back the stock, so it enhances the value of shareholders."

Companies can look after shareholders with dividends, employees with raises, executives with bonuses, invest in infrastructure, hire, or all of the above.

"What better way to show shareholders love than to declare a special dividend or do a stock buyback?" Haller said of public companies. "That's what they may use the money for, instead of increasing U.S. operations or paying people more."

Melville-based Park Electrochemical is declaring about $60 million in dividends (including a $3 dividend) and paying down $69 million in debt to HSBC Bank USA with the help of this provision and lower taxes.

Park estimates paying $20 million in income taxes to bring the money back, compared to $60 million it would have had to pay before the new rules.

"I guess it paid off for us to hang in there to [deliver] the $40 million," CEO Brian Shore said in a conference call.

While firms must pay taxes to bring back money already accumulated abroad, many will receive a get out of taxes free card in the future.

On a go forward basis, U.S. companies' subsidiaries abroad can bring back offshore earnings without paying traditional U.S. income tax, after paying taxes where they're located.

“Much of the world has exactly that provision. So because of that, U.S. companies have always been at a disadvantage,” Nakajima said. “You always have to pay in the country where you’re operating.”

Many companies will be able to bring in money from abroad with no tax on the corporate level, although individuals could be taxed if it’s distributed to them.

“In many cases, there will be no tax. It’s not a pure bonanza,” said Timothy Larson, an international partner at Grassi and Co., in Jericho. “They’ll pay a one-time repatriation tax. I think it will have a positive effect, but I don’t think it will change the landscape of international tax planning.

In the purest sense, paying taxes only where a firm is located is considered the “territorial” system, widely used around the world.

“You hear it all the time that this new act makes the U.S. a territorial taxing jurisdiction. A pure territorial means you only tax from the U.S.,” Nakajima added. “It moves the U.S. toward a territorial system.”

A new system known as GILTI or global intangible low taxed income will be used to tax U.S. firms abroad based on licensing, patents and other assets at a 10 percent rate.

“That’s common with U.S. technology companies,” Larson said. “They develop the technology here and license it to a foreign subsidiary.”

Companies like Apple and Google will be GILTI since they use a lot of technology and patents. Even the Coca Cola Company could be GILTI with its formula considered an intangible asset.

“Short-term, it can’t have a lot of impact on infrastructure,” Nakajima added of the changes. “People have their infrastructure in place, their supply chain in place. It can’t change everything.”

Larson said firms will likely retain foreign subsidiaries abroad rather than folding them directly into U.S. operations, to avoid paying the new, 21 percent standard tax rate for corporate income in the United States.

“I don’t think we’ve seen the last change,” Nakajima said. “A lot of these provisions are probably going to be looked at again in five years. Was there a need to make some changes? Yes. They needed to get the U.S. corporate rate down to make it competitive with the rest of the world.”