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US Tax Reform for Exporters that Both North Carolina Manufacturers and Triangle High Tech Businesses Can Love

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Finance: Banking, Restructuring, Insolvency

The 2017 Tax Cut and Jobs Act ("TCJA") introduced a number of provisions that fundamentally change the way that the US taxes income from the foreign operations of US groups. One of the more favorable TCJA provisions provides for a significantly reduced rate of tax on income that US businesses earn directly from foreign sales. The benefit applies to all US companies, whether US or foreign owned, and in North Carolina it advantages particularly manufacturing companies and high tech businesses. If the NC legislature will act to conform this benefit to the state corporate income tax code, a further reduced state tax rate on this income of approximately 1.5% will be an additional incentive for export companies to set up operations in North Carolina. The US Treasury Department has just published the implementing rules for the foreign sales tax rate benefit. The wait has been worth it as the new rules are generous. Now is the time for US companies to review their foreign sales models to determine the extent to which they can leverage the tax rate benefit for direct foreign sales.

Foreign Sales Income Taxed at 13%. Starting for taxable years beginning after December 31, 2017, qualifying foreign sales income (called "foreign derived intangible income" in the statute) is taxed at an effective rate of 13.125%, a significant reduction in the tax rate compared to the already low 21% US corporate tax rate which was also enacted under TCJA.

Congress enacted this tax rate benefit so that the US would be more competitive globally as an investment base for US companies (whether US or foreign owned) to generate direct foreign sales. Prior to the enactment of TCJA, the US had one of the highest corporate tax rates globally at 35%, and a tax system that encouraged US companies, when operationally feasible, to set up active businesses abroad in low tax or no tax jurisdictions and seek to indefinitely defer the US tax on the sales revenue generated through their foreign affiliates.

Foreign Sales Broadly Defined. Foreign sales income includes goods and services sold to foreign consumers, both businesses and individuals. The sales must be direct to the foreign purchaser and the goods and services must be sold for foreign use. There are significant but manageable documentation requirements in connection with demonstrating the foreign sale and the foreign use. In addition, there is an important inclusion for the 13% tax rate for indirect US defense industry sales to foreign governments under the US Arms Export Control Act of 1976.

Some basic actions. Both US and foreign companies interested in setting up shop in North Carolina should be aware of this foreign sales income opportunity and how the low North Carolina corporate tax rate can complement an export operation. A corporate group can create and concentrate a foreign sales platform in North Carolina for its operations and take advantage of the 13.5% foreign sales rate benefit and the already low 2.5% state corporate income tax rate.

In addition, a foreign group could sell goods and services into Canada and the Americas from its North Carolina subsidiary, as opposed to selling directly from its foreign headquarters base, in order to take advantage of the combined benefit of the 13% federal tax rate and the low North Carolina tax rate. A US group could re-shore from its foreign subsidiaries or transfer from within the US the ownership of valuable, income producing intellectual property to its North Carolina platform.

International challenge, state corporate tax conformity. Some US trading partners have raised the concern that this favorable tax rate regime for US exporters is an illegal export subsidy under international trade agreements but it is far from certain that an international challenge would succeed, for example, before the World Trade Organization. In the meantime, companies of all sizes and sectors will be encouraged to consider how to increase their foreign sales from US operations and rethink any plans to move operations and intellectual property from the US to a foreign business base. The decision for US businesses whether to place ownership of manufacturing capital and intellectual property abroad or in the US will depend on the facts and circumstances of the US business and its foreign market strategy and it is worthwhile to make such an analysis. If the North Carolina legislature could conform the foreign sales benefit to the state income tax calculation, the corporate tax rate would be reduced from 2.5% to about 1.5% on the foreign sales income of NC companies.

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