The Indian perspective on US tax reform legislation

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In brief

US President Donald Trump on December 22, 2017, signed into law tax reform legislation that will have far-reaching implications across the world, including in India. The changes to the US corporate and international tax rules are intended to make the United States more competitive in the global market and could affect global trade and business. The United States and India are significant trade partners and, in light of the changes, Indian companies need to assess the challenges and opportunities presented by the new US tax law.

A key measure in the 2017 tax reform reconciliation act (the Act) is the reduction in the 'headline' federal corporate tax rate from 35% to 21%. This will make the United States more competitive in attracting foreign investment, technology, and other areas.

Another key provision is the imposition of a minimum tax - called the base erosion anti-abuse tax (BEAT) - that effectively will be imposed on deductible payments made by US corporations to related foreign persons. This could make outsourcing to overseas jurisdictions like India less attractive going forward.

The cornerstone of the reforms to the US international tax system is the movement from a worldwide tax regime to a territorial taxation regime with respect to earnings generated in foreign subsidiaries of US companies. As a bridge to the new territorial tax regime, the new US tax law imposes a one-time deemed repatriation 'toll charge' on certain historic earnings of foreign subsidiaries. The toll charge is likely to affect global subsidiaries of US corporations, including those in India.

As a result of the US tax reform, countries including India are likely to reassess their tax systems to maintain competitiveness in the global markets.

This PwC Insight provides a general overview of certain key tax provisions relating to cross-border transactions and how they could affect US corporations with an India presence or India MNEs with a US presence. The provisions of the new law generally are effective for tax years beginning after 2017, but special effective dates apply for particular changes to US tax laws.

In detail

Corporate tax rate reduction

Under the Act, the federal corporate rate is permanently reduced from 35% to 21% for tax years beginning after 2017.

The corporate alternative minimum tax (AMT) has been repealed for tax years beginning after 2017.

Observations

Lowering the US corporate tax rate to 21% is a historic achievement; the United States had one of the highest corporate tax rates among advanced economies. The US corporate tax rate, combined with average state and local corporate tax rates, is reduced from 38.9% to 25.75% as a result of this legislation. While this rate still is two percentage points higher than the 2017 23.75% average rate for all OECD nations, it is lower than that of all other G-7 countries except the United Kingdom.

This reduction in corporate tax rate will make the US more competitive compared to other developed countries and could significantly increase the valuation of US businesses. The reduction also likely will encourage US corporations with overseas operations to shift operations/business to the United States.

The impact of the rate reduction will affect economies, including India, that have significant trade and business with the United States. US tax reform therefore may cause India to consider the potential impact on Indian entities alongwith appropriate measures, if any.

Note: There is a possibility that Indian tax authorities may undertake stricter review of US CFCs of Indian MNEs likely to trigger 'place of effective management' (PoEM) in India. Due to the reduced US federal corporate tax rate, the additional tax recoverable could be material when US corporations have a PoEM in India. Given the above, US corporations should review their business conduct keeping in mind PoEM rules in India.

Territorial taxation

US tax reform has moved the US tax system from a worldwide system toward a territorial tax regime. The new legislation provides a 100% dividend received deduction (DRD) for foreign-source dividends received by a US corporation from specified foreign corporations (SFCs). SFCs include 10%-owned foreign corporations.

Any foreign taxes paid in relation to such dividends by the SFC in a foreign jurisdiction will not be eligible for US foreign tax credits (FTCs).

This provision applies to distributions made after December 31, 2017.

Observations

Under prior law, dividends received from foreign subsidiaries were taxed at 35% in the hands of the US corporation (subject to FTC).

Under the Act, foreign earnings that are not subject to US taxation under the US anti-deferral rules may be repatriated through dividend distributions from an SFC to its US parent corporation without US tax.

However, Indian subsidiaries will remain liable for dividend distribution tax (DDT) in India on declaration of dividends, which may not be creditable in the hands of the US parent corporation because such dividends would be exempt in the United States.

From an overall group perspective, this would generally result in lower taxes on repatriation of profits from an Indian subsidiary to its US parent compared to the previous US tax regime.

Thus, under the new system, the implications of other cash repatriation strategies keeping in mind the tax implications in non-US jurisdiction (including India) and availability of FTC will have to be considered. Additionally, from a longer term perspective, the new US rules may require taxpayers to re-evaluate their existing investment mix.

Deemed repatriation 'toll charge'

As part of the move towards a territorial taxation system, the Act imposes a 'toll charge' on a US shareholder's pro rata share of certain foreign subsidiaries' previously untaxed foreign earnings (determined as of November 02, 2017, or December 31, 2017, whichever is higher).

The toll charge is imposed on the foreign Earnings & Profits (E&P) attributable to cash and other liquid assets at an effective rate of 15.5%, and on all residual foreign E&P at an effective rate of 8%. These effective rates are achieved by granting the US shareholder a deduction as necessary to lower the tax base ultimately subject to US corporate tax. The toll charge can be paid over a period of eight years.

FTCs for the portion of earnings actually subject to US tax (i.e., after the deduction provided against the toll charge) are available to offset the toll charge.

Once the toll charge is paid in the United States on undistributed earnings of a SFC, no further tax will be levied upon an actual distribution by the SFC to its US parent of those earnings.

Observations

The US shift to a territorial taxation system is likely to have far-reaching consequences.

US corporations must pay the toll charge on undistributed E&P accumulated by the Indian subsidiary, even though the E&P is not yet distributed as dividends. Meanwhile, India will continue to levy DDT upon actual distribution of dividends by the Indian subsidiary.

US corporations therefore should review their existing outbound structures, including in India, and consider appropriate cash management strategies.

The mechanics for calculating the toll charge and creditable foreign taxes are complex. Timing differences between payment of the toll charge on undistributed foreign E&P of an Indian subsidiary and availability of the FTC for taxes paid in India will need to be considered.

Base-erosion and anti-avoidance tax (BEAT)

The Act provides for a 10% (5% for

2018) minimum tax levy on payments made to related foreign persons by a US corporation.

The BEAT is imposed if 10% of 'modified taxable income' exceeds the taxpayer's regular tax liability (over certain allowable credits).

Modified taxable income generally means the taxable income of the US corporation plus any base-eroding tax payments made to foreign related persons.

A base-eroding tax payment generally is any amount paid or accrued by the US corporation to a foreign related person that is deductible (subject to certain conditions) and includes payments such as royalties and management fees but does not include cost of goods sold.

This provision is effective for amounts paid or accrued in tax years beginning after December 31, 2017. After 2026, the BEAT will increase to 12.5% (13.5% for certain banks and securities dealers) and cannot be offset by any credits.

Specific exclusions and conditions apply. For example, the BEAT applies to US corporations that have an average annual gross receipts for the preceding three tax years of at least USD 500 million on a group aggregate basis, and for which base-eroding payments to related foreign persons equal or exceed 3% of aggregate deductible expenditures.

Observations

The underlying objective behind the BEAT is to ensure that a minimum 10% tax is paid in the United States by US MNEs that make outbound payments to related parties.

This provision likely will affect US corporations that outsource some business functions to overseas jurisdictions and make payments to foreign related persons.

Some US MNEs have created an Indian presence by outsourcing various business functions such as research and development, Information Technology and Information Technology Enabled Services - related assistance, and back-office finance functions.

Going forward, payments by US corporations to such Indian subsidiaries could trigger the 10% BEAT, subject to satisfaction of the criteria discussed above. Further, in light of the reduction in US corporate tax rates, US corporations could be revisiting their current supply chain structures and cross-border inter-company transactions.

These developments likely will adversely affect Indian companies heavily reliant on outsourcing business from related US corporations. Nevertheless, the skilled workforce and expertise available in India, coupled with the lower cost base, can provide an incentive for US corporations to continue outsourcing to Indian companies.

Separately, questions have arisen whether this unilateral US tax levy may be deemed to violate the principles of global trade agreements to which the United States is a party.

Questions also arise whether these provisions may be deemed to conflict with US tax treaties, because they restrict deductibility of payments made to related foreign parties based on their nationality and therefore, possibly violate the non-discrimination article of such treaties.

Companies, while addressing concerns regarding the impact of the BEAT, will need to comply with the arm's-length standard from the foreign company perspective. Companies also should review the BEPS and OECD initiatives in the context of revisiting their operating models and capital structures.

New limitations on interest deductibility

The Act introduces a new limit on business interest deductions based on 30% of 'adjusted taxable income' (ATI). ATI is similar to EBITDA for tax years beginning after December 31, 2017 and before January 1, 2022. Disallowed business interest may be carried forward indefinitely, for tax years beginning after 2017.

However, for tax years beginning after December 31, 2021, ATI is computed without regard to deductions for depreciation, amortization, or depletion; i.e., the limit will be based on EBIT, and therefore lower.

A specific exemption is provided for taxpayers whose average gross receipts in the preceding three years does not exceed USD 25 million.

Observations

This provision is in alignment with BEPS Action Plan 4. A similar provision enacted in India restricts the tax deduction for interest payments to related parties to 30% of EBITDA.

Given the limitation on interest deductions by US corporations, Indian MNEs with debt funding into US subsidiaries should revisit their existing funding mix and, where necessary, restructure their existing US financing structures and future funding plans.

Other aspects

The Act makes other changes to US domestic tax law, including the following.

- For tax years beginning after 2021, research and experimental expenditures (including software development costs) no longer may be expensed. Such expenditures will have to be capitalized and amortized over a period of five years (15 years when the expenditure is related to research carried on outside the United States).

- The new concept of 'global intangible low-taxed income' (GILTI) requires a US corporation that is a shareholder of a CFC to include the US corporation's share of non-routine returns earned by the CFC in its taxable income. GILTI generally is computed as a CFC's income less 10% of the CFC's tangible assets. The US corporation will receive a deduction of 50% on the GILTI so determined. FTCs are available only up to 80% of the 'tested income' of the CFC.
- Foreign-derived intangible income (FDII) - defined as a US corporation's income derived from selling goods or providing services to foreign persons reduced by 10% of the US corporation's depreciable assets - qualifies for a 37.5% deduction of the FDII computed as above.
- The Act repeals the deemed-paid tax credit for dividends received from a foreign corporation, but retains the deemed-paid tax credit for subpart F and GILTI inclusions. Computing and tracking cumulative tax pools is no longer required. No FTC or deduction is allowed for any taxes paid with respect to any dividend subject to the new deduction for foreign dividends.
- The Act introduces changes to various accounting methods. US corporations will be evaluating the impact of these changes on their existing financial statement positions, assertions, and disclosures, in order to account appropriately for changes in the period of enactment.

For further analysis on the Act, please refer to a detailed Tax Insight from the PwC US Network Firm.

The takeaways

The Act makes sweeping changes to US domestic tax law and the rules regarding cross-border transactions involving US corporations

The Act is intended to make the United States more competitive in trade and business in the global markets and uses a 'carrot and stick' approach seeking to discourage shifting of operations outside the United States, while incentivising domestic investment.

Businesses should endeavour to understand the provisions of the Act and evaluate the impact on operations and investment structures.

Let's talk

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