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Global Business Tax Alert
Sharp Insights

US Tax Law Reform – High Level Analysis and India Impact

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Background

The President has signed into law what was formerly called The Tax Cuts and Jobs Act (TCJA), a massive tax reform package, after a conference agreement was reached by the House and Senate. The formal title of the bill signed into law became "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018". The Act seeks to lower tax on companies, pass-through entities, individuals, and estates and move the US toward a participation exemption system (with partial worldwide taxation of low taxed intangible related income) for taxing foreign-source income of domestic multinational corporations. However, some of the cost of the tax relief is to be offset by provisions that would scale back or eliminate many current-law deductions, credits, and incentives for businesses and individuals. This note outlines some of the key highlights of the Act relevant to US corporations holding Indian subsidiaries and Indian MNCs holding US subsidiaries.

Highlights of the Act

Corporate tax provisions

I Reforms relevant to outbound investments from India

- **Reduction in corporate tax rate –** The Act reduces the corporate tax rate to a flat rate of 21% with effect from 1 January 2018, doing away with the graduated corporate structure.
- **Elimination of Alternate Minimum Tax (AMT) –** The corporate AMT will be eliminated, with an expanded utilization (and potential refundability) of existing AMT credits for years beginning before 2021.
- **Modification of the net operating loss (NOL) deduction –** NOL carry back period is eliminated (as opposed to 2 years in the current law), and NOL carry forward period is extended indefinitely (as opposed to 20 years in the current law). However, the NOL deduction allowed would be limited to 80% of taxable income computed without regard to the NOL deduction.
- **Limitation on business interest** – The Act changes to the limitation on interest deductibility for taxpayers (barring certain small businesses), limiting the deduction to business interest income plus 30% of the taxpayer's EBITDA through 2021 and 30% of EBIT thereafter. In the case of a group of affiliated corporations that file a consolidated return, the Act clarifies that the limitation applies at the consolidated tax return filing level as opposed to an entity level. For partnerships, the limitation is applied at the partnership level, with business interest expense taken into account in determining the partnership's non-separately stated taxable income or loss.
- **Section 199 deduction –** Section 199 manufacturing deduction is repealed (9% deduction for domestic US manufacturing income).
- **Treatment of self-created property –** the gain or loss from the sale of a self-created patent, invention, model or design, or secret formula or process will not receive capital gain treatment. This provision is effective for disposition of such property after 2017.

- **Accounting methods for small taxpayers –** Taxpayers with annual average gross receipts of $25 million or less allowed to use the cash method of accounting and are exempt from the requirement to keep inventories.

Comments on India impact and next steps

- **Low risk distributor** – In view of the reduction in corporate tax rates, Indian MNCs might want to consider the option of converting to a full risk distributor in the US.
- **Agency relationship** - In view of the reduction in corporate tax rates, Indian MNCs might want to reconsider the role and authority of the US subsidiary which acts as an agent in the US.
- **Toll manufacturing** - In view of the reduction in corporate tax rates, Indian MNCs which have toll manufacturing or storage operations in the US might want to consider setting up full-fledged operations in the US.
- **Interest expense limitation** – US subsidiaries which have debt in their books might want to review the investment and debt structures.
- **Investment through intermediary holding company** – Indian MNCs would need to examine the impact of migrating their structure vis-à-vis tax and compliance costs in the intermediate company jurisdiction.
- **Tax risk analysis** – There could be increased focus by Indian tax authorities on transactions with US group entities due to the tax rate difference. Similarly the POEM risk in respect of control and management over the US subsidiary should be reviewed.
- **Short term planning opportunities** – US subsidiaries which don't have a December 31 year end, would have to consider the impact of any financial transactions entered during the period from January 1, 2018 till the 2018 fiscal year-end because some of the tax reform proposals might not apply to such transactions. This could have an impact on corporate tax rate differential, AMT, NOL carry forward, section 199 deductions, tax accounting for income taxes, etc.

II Reforms relevant to inbound investments into India

- **Base Erosion Anti-Abuse Tax (BEAT) –** A US corporation (other than a RIC, REIT or S corporation) with excess base erosion payments for the taxable year must pay a tax equal to the excess of 10% through years 2019 to 2024 (5% for 2018 and 12.5% for 2025 onwards) of its taxable income (determined without regard to deductions attributable to base erosion payments) over its regular tax liability less certain allowable credits. A base erosion payment generally means any amount paid or accrued by a taxpayer to a foreign related party and with respect to which a deduction is allowable, including any amount paid or accrued by the taxpayer to the related party in connection with the acquisition of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation). A base erosion payment also includes any amount that constitutes reductions in gross receipts of the taxpayer that is paid to or accrued by the taxpayer with respect to:
  (1) a surrogate foreign corporation which is a related party of the taxpayer, but only if such person became a surrogate foreign corporation after November 9, 2017, and
  (2) a foreign person that is a member of the same expanded affiliated group as the surrogate foreign corporation.

Certain qualified payments which are reimbursed costs without a mark-up will be excluded from the BEAT. Also, corporations meeting specific gross receipts thresholds will also not be subject to the BEAT.

- **Dividends received deduction (DRD) –** Under the current law, corporation shareholders receiving dividends from certain domestic corporations are entitled to a deduction of 70% of dividends received (from corporations in which it holds less than 20%) and 80% of dividends received (from corporations in which it holds 20% or more). Under the ACT, these brackets have been reduced to 50% and 65%, respectively. However, the 100% DRD would remain intact for dividends received from affiliated group members (where it owns 80% or more).
- **Participation exemption system** - The ACT moves the US from a worldwide tax system to a participation exemption system by giving corporations a 100% dividends received deduction for dividends distributed by a controlled foreign corporation (CFC). No FTC will be allowed in respect of such DRD. However, the cost of acquisition of shares of such CFCs will be reduced by such dividends for computation of capital gains. However, there are specific limitations for any dividend received from a hybrid entity. In order to transition to the new system, there will be a one-time deemed repatriation tax on unremitted earnings and profits payable over 8 years. The tax will be calculated at 8% for illiquid assets and 15.5% for cash and cash equivalents.
- **Global intangible low-taxed income (GILTI)** – A US shareholder is required to include in gross income the amount of its GILTI. However, the US shareholder is allowed a deduction equal to 50% of the GILTI and the amount treated as a dividend by reason of the US shareholder claiming a foreign tax credit as a result of the inclusion of the GILTI amount in income. GILTI is the excess of the shareholder's net tested income over the deemed tangible income return, which is defined as the excess of 10% of the shareholder's basis in tangible property used to produce tested income less the amount of interest expense allocated to net tested income.
- **Research and experimental expenditures –** From 1 January 2022 onwards, research and experimental expenditure are required to be capitalized and amortized over a five-year period. Any expenditure related to research conducted outside the US must be capitalized and amortized over a 15-year period. Software development expenditures shall be treated as research or experimental expenditures. However, there is no change being made to the R&D tax credit.
- **Treatment of hybrid transactions –** Deduction for any disqualified related party amount paid pursuant to a hybrid transaction or by or to a hybrid payment shall be denied. A disqualified related-party amount is any interest or royalty paid or accrued to a related party to the extent that:

  (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes, or

  (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.

Comments on India impact and next steps

- **Tax rate differential** – US MNCs might want to review the level of operations and economic activity carried out outside the US to determine whether the same needs to be realigned to achieve tax optimisation in view of the lowering of corporate tax on profits earned in the US. However companies would need to determine whether potential increase in tax base in the US increases tax risks

and complexities. Also, if India and other countries introduce measures to protect their tax base, it might again change the tax dynamics. Moreover such unilateral action could partially undermine the OECD efforts to ensure each country gets its share of taxes through application of transfer pricing principles.

- **BEAT** – US MNCs might want to review the level of economic activity carried offshore in countries such as India and payments (such as towards back-office operations, pharma and other R&D, software development, financial services etc.) to offshore related group companies including in India due to additional tax exposure under BEAT. Companies would also need to examine which payments would qualify for exclusions from BEAT because of the specific exemptions for cost recharges.
- **DRD** - The policy of dividend declaration to be reviewed in light of 100% deduction for foreign dividends vis-à-vis one-time deemed repatriation tax.
- **R&D outside US** – India plays an important role in acting as a R&D hub for US MNCs; both captive and third party. The required capitalization and longer amortization of R&D expenses for R&D conducted outside the US could impact US MNCs outsourcing R&D activity to India.

III Pass-through provisions

The Act introduces new rules aimed at providing greater parity between the tax treatment of owners of pass-through entities and corporations but also includes guardrails intended to prevent pass-through owners from characterizing wage income as more lightly taxed business income.

IV Individual taxation

- **Reduction in highest rate of tax –** The Act maintains seven brackets as in current law while reducing the highest tax bracket from the current-law level of 39.6% to 37% for single filers with taxable income over $500,000 and married joint filers with taxable income over $600,000
- **Individual alternative minimum tax –** The Act maintains the AMT for individual and fiduciary income taxpayers, albeit with a higher exemption amount of $70,300 for single taxpayers and $109,400 for married taxpayers filing a joint return. Further, the phase-out thresholds are increased to $500,000 and $1 million for single and joint filers, respectively. Both the exemption and phase-out threshold amounts are indexed for inflation
- **Pass-through taxation on individual returns –** The Act includes a 20% deduction against "domestic qualified business income" from a partnership, S corporation, or sole proprietorship for individuals and fiduciaries. However, certain types of business income defined as personal service income is not eligible for the exclusion except for taxpayers with taxable income under $157,000 single/$315,000 married filing joint. Over these thresholds the exclusion is subject to a phase out.
- **Itemized deductions –** The Act substantially increases the standard deduction to $12,000 for single taxpayers and $24,000 for married taxpayers filing jointly (doubling it) and limits certain itemized deductions (such as limiting the deduction for state and local taxes income and property taxes to $10,000). Additionally, it maintains the current-law additional standard deduction for the blind and elderly. Increased standard deductions would allow many individuals to avoid itemizing their deductions.

- **Deduction for personal expenses** – The Act repeals deduction for previously deductible expenses including deductions for most personal casualty losses, tax preparation, unreimbursed business expenses, expenses for the production or collection of income, moving expenses (other than members of the armed forces), effective for tax years 2018-2025. Additionally there is a permanent repeal of the deduction for alimony payments, for agreements executed after 12/31/18 (no sunset)
- **Estate, gift, and generation-skipping transfer (GST) tax provisions –** The current tax regime with respect to the estate, gift, generation-skipping transfer (GST) taxes and the income tax basis adjustment to fair market value at death remain unchanged except that the applicable exclusion amount (the amount that each citizen is entitled to transfer either during life or, if otherwise unused, at death without incurring a current tax) and the GST tax exemption (the amount that may be transferred to skip-persons outright or in trust without giving rise to a present or future GST tax) is doubled to $11.2 million from its existing $5.6 million for transfers occurring after December 31, 2017

Way Forward

The changes could potentially impact several business operations such as intra-group transactions, intellectual property, interest payments, dividends, loss-making operations, etc. From an individual taxpayers perspective too, these changes could have significant impact on tax costs and corresponding ability to claim tax credits in India.

With the process to codify the US tax reforms now complete, it is important to understand the impact these changes could have on the overall business models and tax costs of US corporations holding Indian subsidiaries and Indian MNCs holding US subsidiaries or having operations in the US.

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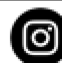

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