International Taxation and US Tax Reform

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Every significant economy in the world is in the throes of transformation on the count of regulation, driven most of all by a need to protect their own turf in times of slow, and now very volatile, growth, but also by a wider concern on tax evasion. Equally, governments the world over are driven by the need to expand their own economic base and greater self-reliance. US tax reform is perhaps the most significant hallmark of this. The country has enacted the first major overhaul of its federal income tax system in more than 30 years. It will have implications on global finances and liquidity as it rolls out, and more so on how global corporations – both MNC and global Indian firms – will now approach investments. In conversations with the India CFO Forum in Delhi and Mumbai, Suchi Lee, Global Leader for International Tax for PwC, shared his outlook for international taxation, drilling deep into the nuances of US tax reform and its implications, both practical and strategic.

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THE CASE FOR US TAX REFORM

Having failed in their efforts to repeal Obamacare, and with mid-term elections coming up, the Republican Party had a strong political impetus to reform the US tax law. The party leadership believes that tax cuts will create jobs, enhance the competitiveness of US-based companies, attract and encourage manufacturing, investment, and the repatriation of earnings retained in foreign countries, and prevent domestic base erosion. There was also a policy impetus to align US tax rates with the global average. Since 1988, the average statutory corporate tax rate in the OECD (excluding the US) has fallen by over 20 percentage points, US rates barely moved, remaining at the upper-end of the scale. The recent reform, though, will take rates down all the way from 35 per cent to 21 per cent, bringing them below the non-US OECD average (~24 per cent). Significantly, too, it moves the US from the current system of taxing the global profits of US corporations – which drove many to create complex structures and retain profits outside America – to a territorial system.

IMPACT ASSESSMENT ON...

America's business landscape

The move is expected to have a domino effect on firms, households, and the broader US economy and for years to come. It will spur economic growth in the short-term, which in turn will boost personal and business income – hopefully driving up overall tax revenues. (Already, companies

Key impact areas of the law include new rules on participation exemption, business interest deductions, base erosion, and intangible income, including from abroad

have started to announce pay hikes and one-time bonuses.) While it is difficult to calculate the precise fiscal impact, government estimates are that it will push up the deficit by USD USD 1.5 trillion over 10 years, though this may be partly offset by rising tax revenues.

The transition to the new law should create arbitrage opportunities owing to changes in account provisions. For instance, companies will instantly be able to avail of benefits such as exemptions on dividends received, and lower tax rates, before the 'bad' provisions, such as toll charges, kick in. There will also be various knock-on effects: companies moving more of their supply chains to the US; greater M&A action on account of lower after-tax cost; increased capital investments; potential increases in dividends and share buybacks; and more small businesses switching from 'S' to 'C' Corporations. However, given the federal structure of the US economy, with each state has its own rules and provisions, the actual impact of tax deductions remains to be seen.

US international tax rules

The Senate Finance bill is similar to the House bill on many aspects, such as a shift to a territorial tax regime, the imposition of a 'toll tax,' the elimination of the indirect foreign tax credit, the modification of the current anti-deferral provisions and rules regarding sourcing income from export sales of inventory, and the repeal of provisions related to investments in US property. The Senate bill, however, differs significantly on the introduction of a new tax on 'global intangible low-taxed income' (GILTI) and 'base erosion and anti-abuse tax' (BEAT) imposed on certain payments by a US corporation to a foreign entity. These changes could have serious implications for both US and foreign taxpayers, in several key areas:

- **Participation Exemption:** Full exemption for foreign dividend derived from non-portfolio shareholding: This provision exempts 95 per cent of certain foreign-source income from US tax. The exemption applies to dividends paid by foreign companies to US corporate shareholders owning at least 10 per cent of the shares. It also applies to capital gains from sales of shares in foreign companies by 10 per cent US corporate shareholders. Thus, the effective US tax rate of 1.25 per cent (25 per cent of the 5 per cent of income that is not exempt) on most foreign dividends create a level playing field for American companies and ends the 'lock-out effect' that discourages them from repatriating foreign earnings (estimated at ~USD 2.5-3 trillion). Many firms are falling in line: Apple, for instance, announced tax payments of USD 38 billion on USD 250 billion of overseas cash.
- **GILTI (Global Intangible Low-taxed Income):** Accrual basis taxation on the half of controlled foreign corporation's passive income with an 80 per cent of the foreign tax credit: This is another anti-base erosion measure that targets US corporations owning Controlled Foreign Companies (CFCs) for US tax purposes. This provision is broadly applied to the excess income of foreign subsidiaries over a 10 per cent rate of routine return on tangible business assets. The US taxable GILTI amount is subject to a 50 per cent GILTI deduction allowance, which is taxed at 21 per cent, implying an effective tax rate of 10.5 per cent. This provision may trigger a greater flow of cash back to the US similar to the 2004 Homeland Investment Act, which caused ~USD 400 billion to flow back to the US. On the upside, some estimates even suggest that about 50 per cent of the total foreign cash holdings of USD 3 trillion may return. 80 per cent of the foreign taxes paid are allowed as a foreign tax credit, thus exempting CFCs,

Indian firms with US operations should see significantly smaller federal tax outflows, possibly spurring new investments. On the flipside, the revised law will also bring several new challenges with it

whose income is subject to tax at an effective rate of 13.125 per cent.

- **Business Interest Deduction: Limitation on interest deduction:** The new tax law proposes deduction of interest expenses of up to 30 per cent of EBITDA. This has serious implications for over-indebted companies, and will discourage other firms from taking on too much leverage. Companies in the US have long been incentivised to borrow on account of low-interest rates and full deductibility of interest expense. While the lower tax rate will boost the corporate bottom-line, the hit to earnings from debt will be much larger. Businesses might therefore curtail their borrowings for unproductive purposes, and some may even try to deleverage to cut costs.
- **BEAT (Base Erosion Anti-abuse Tax):** Additional tax on excess payments to foreign related parties: This applies a 10 per cent minimum tax for taxable income adjusted for base erosion payments. The tax only affects businesses where US gross receipts are in excess of USD 500 million (aggregated on a global group basis), and so has limited application for MNCs without a significant US presence. Further, costs of goods sold are generally excluded from the definition of base erosion payments, while costs of services are not. So, for instance, a US business that imports products for manufacturing and/or resale is likely to be less effected than one that has services in its cost-base. This change would impact India by reducing the cost arbitrage it enjoys, especially in the IT and pharma sectors. For examples, firms with contract manufacturing operations in India and China will see cost increases.
- **FDII (Foreign Derived Intangible Income):** Lowering effective tax rate on foreign-derived royalties and related income by virtue of partial income inclusion: Just like GILTI, FDII only applies to taxable income in excess of a 10 per cent return. (Amounts under 10 per cent are attributable to tangible assets.) The rules apply a deduction of 37.5 per cent on foreign income (from leases, licences or services), yielding an effective US tax rate of 13.125 per cent (21 per cent of 62.5 per cent). It therefore offers a beneficial tax system in situations where US IP generates foreign income, or for services performed in the US using overseas properties. This provision and the GILTI rules are meant to incentivise firms to relocate their assets and operations back to the US. Apple, for instance, has recently announced USD 350 billion worth of investments in America.

Indian companies with a US presence

In view of the significant tax reductions and the repeal of the alternative minimum tax, federal tax outflows for Indian businesses with US operations will reduce significantly. This will particularly benefit the IT, ITeS, pharma and textile sectors. Home-grown firms may even prefer to increase their investments in US firms. Importantly, the new rules retain the existing R&D credits, which provide for either a 20 per cent credit on incremental R&D expenditure, or for a company to deduct its entire R&D expenses, but at a lower rate. On the flip side, there are several provisions that could pose a challenge for Indian companies in the US: the interest deductibility provision, which would make it harder to put debt into the US; and the BEAT and GILTI provisions, which could offset the reduced tax cost. ■

This article is based on discussions of The India CFO Forum in Delhi and Mumbai with Suchi Lee, Global Leader for International Tax for PwC