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U.S. tax reforms – prevention of base erosion

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U.S. tax regime prior to 2018

- Amongst the large economies in the world, the United States had the highest statutory corporate income tax rate → upwards of 40%, after including the corporate income taxes levied by various states and cities.
- The United States follows a worldwide system of taxing global income. Profits and gains earned by overseas entities are also subject to tax in the U.S. when remitted back as dividends. Foreign tax credits reduces or eliminates double taxation.
- This led to "base erosion". U.S. based MNCs relocated their intellectual property and income to lower-tax jurisdictions. They reduced their U.S. tax base through cross-border payments of tax-deductible interest, royalties or other fees.
- Since the repatriation of earnings of foreign subsidiaries of U.S. corporations triggers tax costs in the U.S., several multinational groups retained a significant proportion of their overseas low taxed earnings abroad. It is estimated that U.S. MNCs have nearly $2.6 trillion in untaxed earnings overseas.

Summary of U.S. tax reform on businesses

- The House of Representatives and the Senate passed the "Tax Cuts and Jobs Act of 2017" (TCJA) on December 20, 2017.
- U.S. President Donald Trump signed the TCJA into law on December 22, 2017.
- The TCJA represents the most significant changes to the U.S. tax code since the tax reform enacted in 1986.

Impact of TCJA

- Reduction of corporate tax rates
- Introduction of quasi-territorial taxation
- Taxation to protect base erosion and anti-abuse
- Investment incentive to expensing of asset purchase upfront instead of depreciating

Reduction of federal corporate tax rate

- Reduction of federal corporate tax rate from 35% to **21%**; a 40% reduction, resulting in $1.3 trillion reduction in corporate income taxes

Impact:

- The worldwide average statutory corporate income tax rate in 2017, measured across 202 tax jurisdictions, is **22.96%***. When weighted by GDP, the average statutory rate is 29.41%.
- The worldwide corporate tax rate has declined significantly since 1980, from an average of 38.68% to 22.96%, a 41% reduction over the 37 years surveyed.
- Europe has the lowest regional average rate at **18.35%** (25.58% when weighted by GDP). Conversely, Africa and South America has the highest regional average statutory rate at 28.73% (28.2% weighted by GDP for Africa, 32.98% weighted by GDP for South America). Asia's regional average statutory rate is **20.05%** (26.26% GDP weighted).
- Countries with large economies in the top twenty tax bracket are India (@ 34.61%, including 12% surcharge and 3% cess) and France (34.43%), which rank near the bottom of the category. India holds the 18th spot, while France holds the 20th spot.

*Source: Tax Foundation. Data compiled from numerous sources including: PwC, KPMG, Deloitte, and the U.S. Department of Agriculture.

Reduction of federal corporate tax rate

- Reduction of federal corporate tax rate from 35% to 21%

Impact:

- With this rate reduction, the federal corporate tax rate in the U.S. would be lower than the worldwide average statutory corporate tax rate.
- Reduction in the U.S. federal corporate tax rate may force other countries, including India, to look at their domestic tax rates in order to retain their competitive positions in the world, obviously balancing this with the need to rein in the fiscal deficit.
- With this rate reduction, U.S. should be able to attract many MNCs to relocate their operations back to the U.S. and could discourage profit shifting.

Foreign-source dividends received deduction

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- Introduction of Participation exemption system for taxation of foreign Income

Impact:

- To overcome the "lockout" effect of retaining low-tax earnings abroad, the Tax Cuts and Jobs Act introduces a "territorial" tax system.
- U.S. companies will be exempt from paying taxes in the U.S. on repatriation of foreign profits after 2017.
- Under the "participation exemption system", a U.S. corporation that owns 10% or more of a foreign corporation will receive a 100% Dividends Received Deduction (DRD) on dividends paid by the foreign corporation out of its foreign-source earnings.
- No foreign tax credit or deduction is allowed to U.S. shareholders on dividends for which they receive a DRD. Indirect foreign tax credits (i.e. credits for underlying taxes paid by the foreign subsidiary) is also repealed.
- DRD does not apply to 10% shareholders that are not corporations despite the fact that such shareholders are subject to the deemed repatriation tax.

Transition tax on untaxed foreign earnings

- Deemed repatriation tax

Impact:

- The new tax provision also imposes a **transition tax** on <u>untaxed foreign earnings</u> of foreign subsidiaries of U.S. companies by **deeming those earnings to be repatriated.**
- <u>Foreign earnings</u> held in the form of cash and cash equivalents are taxed at 15.5%, and the <u>remaining earnings</u> in the form of illiquid assets are taxed at 8%.
- The transition tax is applicable on profits of any foreign corporation in which the U.S. shareholder owns at least 10%.
- This one-time mandatory deemed profit repatriation tax is applicable on Post-1986 accumulated Earnings and Profits (E&P) excluding effectively connected income in the U.S. and previously-taxed E&P in the U.S.
- The accumulated, untaxed earnings of a foreign corporation are measured as of November 2, 2017 or December 31, 2017, whichever is higher.

Transition tax on untaxed foreign earnings

- Deemed repatriation tax

Impact:

- A U.S. shareholder may elect to pay its net tax liability on the deemed repatriation in **8 installments** equal to 8% of the net tax liability for each of the first five years, 15% in the sixth year, 20% in the seventh year, and the remaining 25% in the eighth year.
- Foreign tax credits (FTC) are available to corporate U.S. shareholders partially. For repatriated earnings held as cash or cash equivalents, 55.70% of the FTC is disallowed. For other repatriated earnings, 77.10% of the FTC is disallowed.
- A U.S. shareholder's share of the deficit earnings of one foreign corporation may reduce the untaxed earnings of other foreign corporations on a *pro rata* basis. Similarly, a U.S. shareholder that is a member of an affiliated group may offset its share of a foreign corporation's accumulated, untaxed earnings with deficit earnings of a foreign corporation allocated to another member of the affiliated group.

Base Erosion Anti-Abuse Tax (BEAT) on U.S. corporations

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- Abolition of Alternative Minimum Tax (AMT)
- Introduction of Base Erosion Anti-Abuse Tax (BEAT) on U.S. Corporations

Impact:

- The term "base erosion" generally refers to <u>tax reduction</u> strategies adopted by MNCs that take advantage of differences between the tax rates/tax laws of different countries in order to minimize or eliminate the amount of corporate tax paid in a country.
- The earlier U.S. tax regime enabled U.S. based MNCs to shift income from the U.S. to lower-tax jurisdictions and to defer the repatriation of active foreign source earnings. They reduced their U.S. tax base through cross-border payments of tax-deductible interest, royalties or other fees to a foreign parent, subsidiary, or affiliate.
- While a withholding tax applies to such payments, bilateral tax treaties reduced the withholding tax rates and, at times, eliminated it altogether. <u>If a withholding tax does not apply, deductible payments of interest, royalties and management fees reduce the U.S. tax base</u>. Under the earlier U.S. tax regime, there was no minimum tax that had to be paid on certain deductible payments to a foreign affiliate.

Base Erosion Anti-Abuse Tax (BEAT) on U.S. corporations

- Base Erosion Anti-Abuse Tax (BEAT) on U.S. Corporations

Impact:

- To address this lacuna, BEAT is effectively structured as an "alternative minimum tax".
- BEAT applies if 10% of the cross-border payments to related parties exceed the U.S. company's regular U.S. tax liability.
- Large corporations would have to calculate two amounts each year: A and B.

A = the corporation's regular tax liability excluding R&D tax credit (100%) and 20% of production tax credits (modified taxable income).

B = 10% of the corporation's modified taxable income after adding back two amounts: deductible cross-border payments to affiliates and a percentage of any tax losses claimed that were carried from another year.

If A is less than B, then the U.S. government will collect the entire difference as Base Erosion Minimum Tax (BEMT).

The tax rate for calculating B will be only 5% in 2018, making 2018 a transition year.

	Final U.S tax	Beat Calculation	
		Regular	BEAT
Sales income	120	120	120
Cost of Goods Sold	(40)	(40)	(40)
Selling, general & administrative (SG&A) expenses	(10)	(10)	(10)
Subtotal before base eroding payments	70	70	70
Related party royalty	(60)	(60)	-
Taxable income before Net Operating Loss (NOL)	10	10	70
NOL utilisation	(0)	(0)	(0)
Modified taxable income	10	10	70
Ordinary U.S. tax @ 21%	2.1	2.1	
BEAT @ 10%			7
Non R&D business credits	(0)	(0)	(0)
Foreign Tax Credits	(1)	(1)	
R&D Credits	(0.5)	(0)	(0)
Tax liability – Subtotal	0.6	1.1	7
BEMT (excess of BEAT over regular)	5.9	5.9	
Final U.S. tax	6.5		

Source: Ernst & Young LLP

Base Erosion Anti-Abuse Tax (BEAT) on U.S. corporations

INTERNATIONAL TAX RESEARCH AND ANALYSIS FOUNDATION

- Base Erosion Anti-Abuse Tax (BEAT) on U.S. Corporations

Impact:

- "Applicable taxpayers" are corporations (other than Regulated Investment Companies, REITs, and S corporations) with average annual gross receipts of at least $500 million for the three-year-tax period ending with the preceding year and a ''base erosion percentage'' of at least 3% for that taxable year.
- The ''base erosion percentage'' for any tax year is equal to the aggregate amount of "base erosion tax benefits" of the corporation for the tax year divided by the aggregate amount of specified deductions allowable to the corporation for the tax year.
- Generally, "base erosion payments" are tax-deductible cross-border payments to related parties, <u>excluding payments subject to full 30% U.S. withholding tax and cross-border purchases of inventory included in cost of goods sold</u>.
- It includes any amount accrued or paid by the taxpayer to the related foreign party in connection with the acquisition of property which are subject to depreciation or amortization.

Base Erosion Anti-Abuse Tax (BEAT) on U.S. corporations

➢ Base Erosion Anti-Abuse Tax (BEAT) on U.S. Corporations

Impact:

- BEAT would not be a withholding tax since it is a minimum tax on the U.S. payor, and it is intended as a backstop to prevent further U.S. base erosion. It would not be eligible for foreign tax credit.
- This provision is aimed at domestic corporations that significantly reduce their U.S. tax base by making large deductible payments such as royalties or interest to foreign related parties.

FDII and GILTI

- U.S. Corporations migrated their intangible property offshore in order to prevent / defer significant income derived from such IP out of the U.S. tax net.
- One of the objectives of the Tax Cuts and Jobs Act (TCJA) is to put an end to this practice.
- The TCJA introduces incentives for corporations that leave their valuable IP in the U.S., and at the same time penalize corporations that have migrated IP offshore to a Controlled Foreign Corporation (CFC).
- The incentive is provided in the form of Foreign Derived Intangible Income (FDII).
- The penalty is on Global Intangible Low Taxed Income (GILTI).

Foreign-Derived Intangible Income (FDII)

- Current year taxation of Foreign-Derived Intangible Income (FDII)

Impact:

- Foreign Derived Intangible Income (FDII) is a corporation's deemed intangible income.
- It is category of income that is not specifically traced to intangible assets. The new tax provision assumes a deemed rate of return on depreciable business assets and the residual income (gross income less notional income from depreciable assets) is the income deemed to be generated by Intellectual Property.
- Specifically, FDII is income that is in excess of 10% of a taxpayer's Qualified Business Asset Investment (QBAI). A taxpayer's QBAI are the assets used by the taxpayer in a trade or business that are depreciable under IRC § 167. Income in excess of 10% of the QBAI is the Deemed Intangible Income of that taxpayer.
- To the extent this income is received from non-U.S. persons (<u>related or unrelated</u>) for services provided to persons outside the U.S. or towards property that is sold, leased or licensed for use outside the U.S, it is the taxpayer's FDII.

Foreign-Derived Intangible Income (FDII)

- Current year taxation of Foreign-Derived Intangible Income (FDII)

Impact:

- The U.S. taxable FDII amount is subject to a 37.50% deduction allowance (up to the end of 2025), and is subject to tax at 21%, reducing the ETR on FDII to 13.125%.
- FDII is in effect a lower tax on income from exports of property or services.

Global Intangible Low-Taxed Income ("GILTI")

- Minimum tax on U.S. shareholders of CFCs with "global intangible low-taxed income"

Impact:

- GILTI is pro rata attribution of CFC income to a U.S. shareholder, as deemed dividend.
- A notional rate of return (presently 10%) is applied on the business assets of a CFC. Such income shall not be subject to U.S. taxation.
- Income above the notional rate of return will be deemed dividend income for the U.S. shareholder of the CFC, on a pro rata basis.
- Specifically, GILTI is pro rata attribution of CFC's gross income to a U.S. shareholder,

(i) in excess of 10% of a CFC's Qualified Business Asset Investment (QBAI) over the CFC's net interest expense,

(ii) as of the close of each quarter of the taxable year.

- A CFC's QBAI is defined as the CFC's fixed assets that are depreciable as trade or business assets. It does not include the CFC's intangible property such as patents, trademarks and other intangibles that are amortizable under IRC § 197.

Global Intangible Low-Taxed Income ("GILTI")

➢ Minimum tax on U.S. shareholders of CFCs with “global intangible low-taxed income”

Impact:

- Corporate U.S. shareholders are eligible for a 50% deduction allowance (up to the end of taxable year 2025) on the net U.S. taxable GILTI amount and is subject to tax at 21%, reducing the effective tax rate on GILTI to 10.5%.
- Double tax relief is restricted to 80% of the foreign income taxes paid and are not allowed to be carried back or forward to other tax years. Such foreign tax credits can only be used to offset tax on GILTI inclusions and not tax on other types of income.
- Consequently, if the GILTI foreign profits are subject to non-U.S. tax at a minimum rate of 13.125%, no further U.S. tax will be paid on such income due to FTC (i.e. 10.5% U.S. effective tax rate on GILTI divided by 80% FTC = 13.125%).
- From taxable year 2026, GILTI deduction will be reduced to 37.5%, increasing the effective U.S. tax rate on GILTI to 13.125% (i.e. 62.5% @ 21%). The rate of foreign taxes required to pay no additional U.S. tax under the GILTI regime increases accordingly to 16.406% (13.125% divided by 80% = 16.406%) from 2026.

Global Intangible Low-Taxed Income ("GILTI")

- Minimum tax on Global Intangible Low-taxed Income (GILTI)

Impact:

- A CFC is any foreign corporation of which more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of its shares is owned by U.S. shareholders.
- A U.S. shareholder is any U.S. person who owns 10% or more of the total combined voting power of all classes of voting stock of the foreign corporation.
- The GILTI computation is done at the shareholder level. Consequently, income in one CFC can be offset by losses in another CFC if there is a common shareholder.
- The tax on GILTI is intended to reduce the incentive to relocate CFCs to low-tax jurisdictions, since any tax savings achieved by the CFC may be partially offset by an increase in taxes to the U.S. shareholders.
- GILTI will be applicable on U.S. shareholders of CFCs with relatively high interest expenses; CFC with little basis in depreciable property such as service corporations and CFCs with high value intangibles.

Limits on business interest deductions

- Limits on business interest deductions

Impact:

- Use of debt to finance U.S. operations is widespread in U.S. inbound structures.
- From tax year 2018, deduction for interest paid or accrued on debt allocable to a trade or business will be limited to the sum of:

(i) the interest income of the taxpayer allocable to a trade or business, and

(ii) 30% of the "adjusted taxable income" of the taxpayer for the taxable year.

- Taxpayers (other than tax shelters) with average annual gross receipts of $25 million or less for the three previous tax years are exempt from the interest deduction limitation.
- For tax years beginning in 2018 through 2021, adjusted taxable income is calculated by adding back depreciation, amortization and depletion deductions (i.e., similar to EBITDA). From tax year 2022, adjusted taxable income is determined without adding back depreciation, amortization and depletion deductions (i.e., similar to EBIT).
- Disallowed interest may be carried forward to future years indefinitely.

Limits on business interest deductions

- Limits on business interest deductions

Impact:

- This limitation restricts the tax benefits arising from debt structures.
- This limitation and the BEAT provision on related party payments may lead to re-evaluation of the capital structure of U.S. subsidiaries – both existing and proposed.

Impact of U.S. tax reforms on Indian companies

- In India, the new residency test for companies based on the Place of Effective Management (POEM) poses several risks for outbound structures. Under this test, foreign subsidiaries of Indian companies could be treated as being tax residents of India and taxed on their global income (subject to credit in respect of foreign taxes paid in the country of incorporation).
- Typically, there would be little incentive for the Indian tax authorities to scrutinize subsidiaries incorporated in high tax jurisdictions from a POEM perspective, since there would be little, if any, incremental tax revenues accruing to India after giving credit for overseas taxes.
- This may no longer hold true in the U.S. context under the new corporate tax rate structure. Hence, companies may be required to pay closer attention to POEM related risks in respect of their U.S. subsidiaries, going forward.
- With the reduction in U.S. tax rates, there is increased need for U.S. corporations to evaluate their tax costs overseas, including specifically in high tax countries like India. This may warrant a rethinking of the entire India tax strategy including funding options for Indian entities, transfer pricing supply chain policies as well as repatriation options.

Impact of U.S. tax reforms on Indian companies

- Similarly, Indian MNCs operating in U.S. as subsidiaries — especially in the information technology space, may want to keep more profits in the U.S. rather than in India, to minimise the overall tax burden and use those profits to expand globally.
- This could impact the transfer pricing policies presently followed by U.S. MNCs in remunerating their Indian subsidiaries and Indian MNCs remunerating their subsidiaries in the U.S.
- Under the deemed repatriation provisions relating to accumulated post 1986 earnings, tax may become payable in the U.S., even though the earnings may not have been actually repatriated to the U.S. In addition, the tax reasons for retaining profits overseas no longer remain. This could lead to cash flow issues, which in turn may necessitate actual distributions from India. Such actual distributions would entail a significant tax cost for the Indian subsidiary, which again may not be fully creditable against U.S. taxes.

Impact of U.S. tax reforms on Indian companies

- BEAT could lead to a significantly increased tax cost on companies that routinely make payments to affiliates in India, including towards outsourcing and sub-contracting of work. This increased cost could make outsourcing of activities to India less attractive.
- Lower tax rates and other base erosion rules forming part of the tax reform could lead to U.S. companies unwinding these arrangements and moving assets and people back into the U.S. This may particularly be relevant in the context of businesses in the technology and pharmaceutical sectors, where existing intellectual property structures may warrant a complete overhaul.
- A lower tax rate will generally lead to increased valuations of U.S. business. However, in the context of acquisitions, one may also need to factor in the impact of changes relating to use of NOLs, deferred taxes and other tax attributes, such as available foreign tax credits. Specifically, the Tax Cuts and Jobs Act could make tax attributes less valuable, while deferred tax liabilities would become less costly.
- New acquisitions could be made more favourably through “asset” purchases or “deemed asset” purchases, based on the immediate expensing rule for new asset investment.

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THANK YOU