The Tax Reform enacted by Congress significantly modifies key areas of US tax law, including many international tax provisions. These changes will have far-reaching implications, both domestically in the US, as well as in a cross-border context. It will affect both foreign investors in the US as well as overseas subsidiaries of US corporations.

The Indian tax landscape also has seen radical change over the last few years with the renegotiation of its tax treaties with Mauritius, Cyprus and Singapore, the introduction of the buyback tax and equalization levy, and a phase-out of tax holidays. Businesses with interests in India and the US must therefore look closely at the changes made to see how they affect their overall tax strategy in both countries.

The key features of this law include:

- Rate cuts for individuals, “pass through” businesses, as well as corporations
- Exemption for overseas dividends and deemed repatriation of existing overseas earnings and profits
- Limitations on interest deductibility and other “base erosion” rules, including a new “minimum tax” on payments by US corporations to related foreign entities
Individuals:

Individual tax reform generally applies to all US persons, including green card holders and US citizens abroad, including India. This too, in the long run, may have ramifications in the cross-border context. The US relies heavily on revenues from personal or individual taxes and does not have a VAT or GST regime.

Some of the principal changes in this regard are summarized below:

**a. Rate Reform**

Individuals will enjoy tax rate reductions across multiple income levels. The top rate will now be 37%, which is lower than what was proposed in the original House and Senate Bills. However, these reductions are set to expire after 2025.

**b. Standard deduction increased**

The “standard deduction,” for taxpayers who do not itemize deductions, has been increased significantly, although “personal exemptions” have been eliminated. This too is a temporary measure and will expire after 2025.

Many other deductions are eliminated or limited in the tax reform, including historically popular provisions for deducting mortgage interest and state and local taxes (SALT).

**c. Individual AMT**

The individual AMT regime is being retained, but with higher exemption and phaseout amounts.
d. Estate Taxes

The exemption from the Estate Tax would be doubled to over $11MM, adjusted for inflation. This increased exemption also expires in 2025.

Businesses:

Individual tax reform generally applies to all US persons, including green card holders and US citizens abroad, including India. This too, in the long run, may have ramifications in the cross-border context. The US relies heavily on revenues from personal or individual taxes and does not have a VAT or GST regime.

Some of the principal changes in this regard are summarized below:

a. Corporate Tax Rate Reduction

Currently, most corporate income is subject to tax at 35%. This will be reduced to 21% from 2018 onwards and is intended to be permanent.

b. Business Investment

Immediate write offs are provided for new business investments in certain depreciable personal property. This benefit will phase out beginning after five years.

c. Modification of Net Operating Losses (NOL) deductions

Currently, NOLs in any given year can be carried back two (2) years and carried forward for twenty (20) taxable years.

For losses arising from 2018, an 80% limitation annual limit on post 2018 NOL set offs will be applied, no carrybacks will be permitted, but NOLs can be carried forward indefinitely.

d. Repeal of Alternative Minimum Tax (AMT)

The corporate AMT will be completely eliminated. Yet, taxpayers can use existing AMT credits to offset their regular tax liability, as well as claim refunds of AMT credits subject to certain limits.

e. Taxation of business income from pass through entities

Businesses organized as sole proprietorships, partnerships, limited liability companies (LLCs) and “S Corporations” generally are treated as “pass through entities” under the Internal Revenue Code. Owners of such entities are taxed at their regular tax brackets in respect of their share of income from such entities.

Beginning in 2018, and subject to limitations for service oriented businesses and using assumptions for wage income, “pass through” beneficiaries will be entitled to a 20% deduction, reducing the tax rate on such income to 29.6%.

f. Dividends Received Deduction

Historically, to prevent double taxation of corporate earnings, corporations have been entitled to a dividends received deduction (DRD) of 80% for substantial investments of 20% or more and 70% for other noncontrolling investments. The DRD for such investments would be reduced to 65% and 50% respectively.
AN INDIAN PERSPECTIVE

The first and most significant impact of the proposals is that a corporate tax rate of 20% will make the US a far more attractive destination for foreign investment. One therefore would expect increased outbound investments from India into US ventures, as well as increased acquisitions of US businesses. A few important aspects that one would need to consider in this regard are set out below:

1. A lower tax rate will generally lead to increased valuations of US 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 (see discussion below). Specifically, the Tax Cuts and Jobs Act could make tax attributes less valuable, while deferred tax liabilities would become less costly.

2. New acquisitions could be made more favourably through “asset” purchases or “deemed asset” purchases, based on the immediate expensing rule for new asset investment.

3. “Start-up” businesses could face cash tax outflows, despite the availability of significant NOLs.

4. Historically, a good deal of tax planning involving the US has involved migrating of intellectual property and high value functions to lower tax jurisdictions. This comes at a cost, and often leads to complex supply chains and operational structures as well as litigation risks. Lower tax rates and other base erosion rules forming part of the tax reform could lead to businesses unwinding these arrangements and moving assets and people back into the United States. 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.

5. 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 US context once the rate cuts take effect. Hence, companies may need to pay closer attention to POEM related risks in respect of their US subsidiaries going forward.
Under current law, US persons, including US corporations, are taxed on their global income. Foreign income earned by a foreign subsidiary of a US corporation generally is not subject to taxes in the US until the income is distributed or "repatriated." Foreign tax credits are made available to offset the US taxes owed on such income, thereby avoiding double taxation.

Since the repatriation of earnings of foreign subsidiaries of US corporations triggers tax costs in the US, several multinational groups have a significant proportion of their overseas low taxed earnings retained abroad. To overcome this "lock-out" effect, the Tax Cuts and Jobs Act envisages a "territorial" system and exempts US corporations in respect of dividends received from their foreign subsidiaries. More specifically, dividends received by a US corporation from specified 10-percent owned foreign corporations will be entitled to a 100% deduction.

The "territorial" regime would be made applicable for distributions made after 2017. As a corollary, indirect foreign tax credits (i.e. credits for underlying taxes paid by the foreign subsidiary) would be repealed. The Act also includes "minimum tax" provisions of 10.5%-13.125% to ensure that certain foreign earnings ("GILTI" or "global intangible low-taxed income") are not accumulated in tax havens or low or minimally taxed regimes, with income earned at rates of 13.125%-16.406% generally outside the scope of the "minimum tax."

Historical earnings (earnings and profits) however would be subject to a one-time transition tax of 8% or 15.5% on the "deemed repatriated" earnings amount, depending on whether the earnings are in the form of cash or non-cash assets. Foreign tax credits triggered by such deemed repatriation would be made partially available, to offset the US tax. An option has also been given to the US shareholder to defer the payment of this tax liability over an 8-year period in instalments.
AN INDIAN PERSPECTIVE

The above changes would significantly affect US inbound structures in India. Specifically:

1. India has a corporate tax rate of approximately 35% as well as an additional corporate level tax on dividends and share buybacks of approximately 20%. The combined effect of these rates was higher than the highest US corporate tax rate of 35%, which would have led to a tax leakage if Indian profits were fully repatriated to the US (assuming that there is no low taxed foreign source income of the US parent against which the excess Indian credits could be offset). Once US tax rates fall to 21%, the tax leakage could see a significant increase. This in turn may affect the economics of the overall Indian investment.

2. With the reduction in US rates, there is increased need for US corporations to take a hard look at 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, debt infusion, transfer pricing and supply chain policies, consolidation as well as repatriation options.

3. Cash repatriation from India also assumes importance in the context of the tax reform proposals. Historically, cash repatriations from India were undertaken through a Mauritius SPV tendering shares in a buyback and claiming the capital gains exemption under the India- Mauritius treaty. This route was however blocked with the introduction of the Buyback Tax, which applied in the hands of the Indian company on share buybacks (of unlisted shares). US tax reforms may exacerbate this situation, as the Indian corporate tax plus dividend distribution tax / buyback tax will not be creditable in the US, in view of the exemption for foreign dividends.

4. As regards the deemed repatriation provisions relating to accumulated post-1986 earnings, tax may become payable in the US, even though the earnings may not have been actually repatriated to the US. 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 in the hands of the Indian subsidiary, which again may not be fully creditable against US taxes. This once again underscores the need for long term planning for cash extractions from India.
Generally, under current law, interest accrued or paid by a U.S. corporation is deductible in the computation of its taxable income. The proposals envisage putting in place additional limitations on the deductibility of interest by a US Corporation. Specifically, deductible interest expense of a US corporation will be limited to 30% of its “adjusted taxable income” for the relevant year, before taking into account depreciation (but only for taxable years through 2022). Disallowed interest may be carried forward to future years. And, special rules apply to the limitation in the case of partnership income.

Interestingly, the “proportionate” debt rule for “international financial reporting groups” or “worldwide affiliated groups” did not survive into the final bill.

Use of debt to finance US operations is widespread in US inbound structures. These proposed limitations may potentially limit the tax benefits that arise in debt structures. Such structures may not prove as advantageous from a tax perspective going forward, and there may be a need to reconsider the capital structure of US subsidiaries – both existing and proposed.
Currently, foreign corporations generally are not subject to taxation in the US unless their income is either effectively connected with a trade or business in the US or is US source fixed or determinable annual or periodical (FDAP) income.

The 20% excise tax proposed in the House Bill has been dropped. However, the final law incorporates the Senate’s 10% minimum tax on US persons making payments (including interest, but not cost of goods sold) to foreign related parties. For the year 2018 though, the applicable rate is 5%. From 2019 onwards, the 10% rate becomes applicable. This tax would not be a withholding tax limited by tax treaties, since it is a minimum tax on the US payor, and it is intended as a backstop to prevent further base erosion from the US, above certain limited thresholds. It is not clear whether the 10% tax will survive scrutiny under US trade commitments.
AN INDIAN PERSPECTIVE

To some extent, the 10% minimum tax resembles the equalization levy that India introduced in 2016, since this is also a tax on payments made to non-residents who do not have a taxable presence in the country.

These have several important consequences that taxpayers should bear in mind:

1. If enacted, the Base Erosion Anti-Abuse tax could lead to a significantly increased tax cost on companies that routinely make payments to affiliates in India, including the case of outsourcing and sub-contracting of work. In many cases, this increased cost could make the outsourcing of activities to India uncompetitive.

2. This tax may not be available as a credit against the tax payable in India by the Indian related party. This is because an Indian resident earning income from the US is entitled to credit under the India-US tax treaty only in respect of US tax on income which may be taxed in the US in accordance with the Convention. This minimum tax neither a tax on the Indian resident nor is it in accordance with the provisions of the India-US treaty.

3. Unlike the House excise tax, no relief in respect of foreign taxes is contemplated against the Senate’s minimum tax.
Dhruva Advisors LLP is a boutique tax and regulatory services organization, working with some of the largest multinational and Indian corporate groups. We bring a unique blend of experience, having worked for the largest investors in India, advising on the largest transactions and on several of the largest litigation cases in the tax space. We work closely with regulators on policy issues and our clients on tax advocacy matters. We believe in thinking out of the box, handholding our clients in implementation and working to provide results.

Key differentiators:
- Strategic approach to complex problems
- In-depth, specialised and robust advice
- Strong track record of designing and implementing pioneering solutions
- Trailblazers in tax controversy management
- Long history of involvement in policy reform
- Technical depth and quality

Dhruva has presence in Mumbai, Ahmedabad, Bengaluru, Delhi, New York, Singapore and Dubai. The key industries that the team advises on include financial services, IT and IT-enabled services (ITES), real estate and infrastructure, telecommunications, oil and gas, pharmaceuticals, chemicals, consumer goods, power, as well as media and entertainment.

Dhruva Advisors is a member of the WTS Alliance, a global network of selected firms represented in more than 100 countries worldwide.

Our recognitions
- Dhruva Advisors has been named “India Tax Firm of the Year 2017” at International Tax Review’s Asia Tax Awards 2017.
- Dhruva Advisors has been consecutively recognized as a Tier 1 Firm in the International Tax Review, World Tax Guide 2016 and 2017 to the world’s leading tax firms.
- Dhruva Advisors has also been awarded the Best Newcomer of the Year 2016 - ASIA by the International Tax Review.