US tax reforms: A clause to watch for a section of IOPs

Companies operating via subsidiary model in the US may attract higher tax

- **Senate Republicans have passed what is said to be an overhaul of the existing US tax code – USD1.5t tax bill over 10 years.**
- **One of the reforms is BEAT (Base Erosion Anti-Abuse Tax) – to deter US-based MNCs from shifting profits to lower tax jurisdictions.**
- **BEAT impacts IT services companies that operate under the subsidiary model in the US (TCS, HCLT, CTSH). The impact is unlikely on companies operating under the branch route, such as INFO and WPRO.**
- **Impacted service providers, however, can circumvent the impact in the medium term by gradually resorting to the branch mode of operations.**
- **If exemption to "Cost of Goods Sold" in the bill is applicable to Services too, then the impact will be negligible. However, clarity on that is yet to emerge. Meanwhile, Captives do not have a similar circumvent, which dents their attractiveness for now.**
- **Over the longer term though, the regulator's motive of reducing job outsourcing remains an overhang, even if the tax bill does not address it fully.**

Key clause in the bill that matters in Indian IT context

- Senate Republicans have passed what is said to be an overhaul of the existing US tax code – USD1.5t tax bill. We highlight a section of this bill that intends to prevent US MNCs from reporting profits in lower tax jurisdictions rather than the US. This might have a derivative impact on some Indian IT companies as well.
- This is through Base Erosion Anti-Abuse Tax (BEAT). The BEAT is an alternative minimum tax designed to curtail excessive earnings stripping through payments to foreign affiliates. The tax is imposed on large groups (at least USD500m annual gross receipts), and is equal to the amount that a company's taxable income, computed without regard to base eroding payments to related corporations (taxed at a 10% rate), exceeds the company's regular corporate tax liability.
- The other aspect that this addresses in part is to deter the practice of importing from foreign regions, thereby spurring the American Jobs agenda. However, the bill falls short of addressing this issue in totality, given that while it imposes tax-based restrictions on importing from affiliates, it misses out on rendering the same via third-party exporters.

What does it mean in the context of Indian IT Services?

- The operating model of India-based IT services providers can be broadly divided into – [1] branch model, whereby the contracts are signed by India-based parent and onsite services are rendered from overseas branch and [2] revenues are accrued to the US subsidiary, which in turn sources the services from its India parent.
- Here, companies such as TCS, CTSH and HCLT – which operate under the subsidiary structure in the US – come under the ambit of BEAT. That means that their payments to the Indian parent (the transfer pricing arrangements) come

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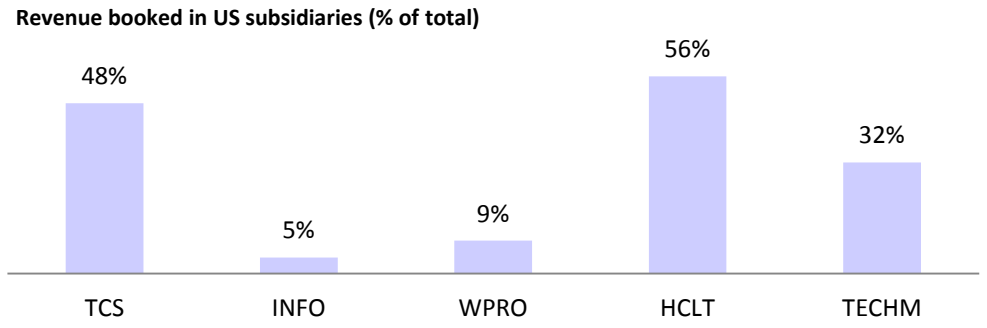
under the fold of "payment from US based company to foreign affiliate," and thus, will be taxed higher. According to our estimates, this can dampen earnings anywhere between 4% and 10%.

- That said, such an impact can be circumvented by resorting to branch model, similar to INFO's. Given that the bill comes into effect from 1 January 2018, contracts that continue operating under the current arrangement may be in for greater taxation.

Exhibit 1: TECHM is high due to acquisitions such as LCC and not subsidiary structure



Source: Company, MOSL

Impacts Captives – opportunity for Indian IT?

- While the impacted Indian providers (for now) have an offset via recourse to the branch route, the captives clearly get impacted from the bill have no such circumvent.
- This makes their services more expensive to their parent organizations, and potentially ups the competitive advantage of third-party providers – at least till no leveling regulation is enforced upon them. However, all this is subject to clarity on one ambiguity (explained below).

Nasscom data on GIC (Captives)

- GICs account for 8-10% of IT services exports growing at 8% in FY2017
- 350+ GICs, >1.8 lakh employees; Bengaluru, NCR and Mumbai leading locations
- Software and BFSI account for 40% share of GICs
- Share of IT GIC revenue from other geographies has increased while North America and Europe still constitute major share
- ADM remains the prime focus for IT GICs accounting for more than 50% of total employees

Source: Company

One element of ambiguity – COGS

The bill does state that cross-border purchases of inventory included in cost of goods sold are omitted from the deductible base erosion payments. This is a reprieve clearly as the burden of taxation drops significantly – something that holds for the manufacturing industries. However, the applicability of the same to Services remains unclear. The clarity shall emerge once the guidelines for the same are out.

Conclusive thought: Regulations remain an unwelcome long-term overhang

- There may be an interim period of impact for the vendors with subsidiary structures in the US, but we expect that to be dealt with gradually over the medium term.
- While the tax bill did not offer anything directly antagonistic for Indian IT, the American-jobs-first point of view in certain aspects of the bill is visible. Furthermore, there may yet be more to tackle the outsourcing of work to third-party providers (IT Services and others) in due course, which remains an overhang. This uncertainty in the past year has also led to delayed decision on deals and deferred ramp-up in those already signed, hurting industry growth.

Exhibit 2: Comparative valuation

Company	MCAP	Rating	TP	P/E (x)			RoE (%)			FY17-19E CAGR. %	
	USD b		(INR)	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	USD rev.	EPS
TCS	76.1	Neutral	2,450	19.6	17.1	16.3	30.6	33.5	30.6	8.1	6.5
Infosys	34.6	Buy	1,100	15.9	14.9	13.4	21.8	22.5	22.8	7.4	4.0
Wipro	21.8	Neutral	280	15.5	14.8	13.4	17.0	16.7	16.4	6.3	9.0
HCL Tech	18.8	Neutral	970	13.8	12.8	12.3	25.9	25.6	24.0	9.9	6.7
TechM	7.2	Buy	560	13.6	12.9	11.3	18.9	18.2	18.3	9.3	10.3
Tier-I Agg	**158.6**			**15.7**	**14.5**	**13.4**	**22.8**	**23.3**	**22.4**		
Mphasis	2.3	Neutral	670	17.3	15.8	14.4	14.6	17.3	17.7	9.5	8.7
L&T Infotech	2.7	Buy	1,200	16.5	15.4	14.3	35.2	29.6	25.9	11.3	9.1
Mindtree	0.7	Buy	600	20.2	16.4	13.3	17.3	21.2	23.5	8.9	18.7
KPIT Tech	0.5	Neutral	160	14.5	12.2	10.0	14.1	14.5	15.2	10.3	8.6
Cyient	0.9	Buy	600	15.5	13.4	12.2	17.4	18.3	18.1	12.7	16.9
Hexaware	1.5	Neutral	270	19.9	19.0	16.9	26.4	23.4	22.3	12.3	11.6
NIIT Tech	0.6	Neutral	600	14.6	12.7	11.4	15.1	16.4	17.1	0.8	15.0
Persistent	0.8	Buy	780	15.0	12.3	10.6	17.9	20.8	23.5	11.1	18.0
Zensar	0.6	Buy	1,020	16.1	11.7	10.5	15.3	18.4	17.8	7.8	18.2
Tier-II Agg	**9.9**			**16.6**	**14.3**	**12.6**	**19.3**	**20.0**	**20.1**		

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