AN ALERT FROM THE BDO TECHNOLOGY PRACTICE

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TAX REFORM'S POTENTIAL IMPACT ON TECH

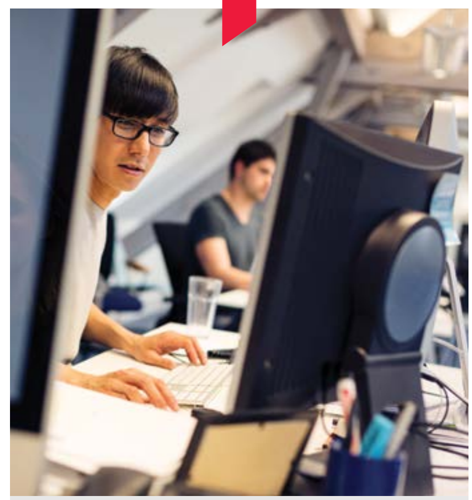
By David Yasukochi

On Dec. 2, the Senate passed its version of proposed tax reform legislation, the "Tax Cuts and Jobs Act," on a vote of 51-49. The House had previously passed its own tax bill on Nov. 16, 2017. Currently, both bills reside with a conference committee for reconciliation. This sets the stage for a possible enactment of a final bill before the New Year.

With each bill proposing slightly different provisions, it's important that tech companies familiarize themselves with the proposals to understand how they may be impacted in the future. Should legislation pass, most provisions of both bills will be effective starting in 2018.

WHAT'S AT STAKE FOR U.S. TECH?

The key highlights of the House and Senate tax bills, as well as their potential impact on tech companies, are summarized below.



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BDO works with a wide variety of technology clients, ranging from multinational Fortune 500 corporations to more entrepreneurial businesses, on myriad accounting, tax and other financial issues.

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PROVISION	IMPLICATIONS FOR TECH COMPANIES
Reduce the Corporate Tax Rate (House & Senate): Both the House and Senate bills propose to reduce the corporate tax rate from 35 to 20 percent. The Senate bill, however, would delay this implementation until 2019.	A reduction in the corporate tax rate would be a boon to tech companies overall, as they have often protested that the current U.S. corporate tax rate is among the highest of all the developed nations. While all tech companies are looking forward to the change, smaller tech companies that operate domestically are especially excited: This is because many still face high effective tax rates when compared to their global tech peers, like Google or Apple, who are often able to enjoy lower effective rates due to sophisticated tax planning, including base shifting and other measures. Because smaller companies often have more limited bandwidth, resources, and footprint, they may be unable to implement as effective a global tax structure as their global tech counterparts. Thus, the corporate tax reduction would be a huge win.
Eliminate Ability to Carryback Net Operating Losses (House & Senate): Both the House and Senate proposals will generally eliminate taxpayers' abilities to carryback net operating losses (NOL), and will limit the use of NOLs to 90 percent of taxable income (it is down to 80 percent after 2022 in the Senate bill). NOLs will no longer have an expiration period.	In situations where tech company earnings are volatile, the restrictions on the carryback and use of NOLs could present a significant cash flow obstacle.
Repeal the Domestic Activities Deduction (DPAD) (House & Senate): The House and Senate bills both propose to repeal the Domestic Activities Deduction (DPAD), which was originally enacted to encourage manufacturing within the U.S. For C corporations, repeal is effective one year later (years beginning after 2018) in the Senate version.	While the impact of this repeal is somewhat muted, since a good portion of hardware manufacturing activities are done offshore, many software developers were able to take advantage of the DPAD.
Create a Territorial Tax System (House & Senate): Both bills propose the creation of a territorial tax system, which would tax U.S. companies only on their domestic income vs. their worldwide income.	The creation of a territorial tax system is a provision that has long been on the tax wish list for U.S. tech companies, who have long complained that the current tax framework has made them uncompetitive with their global peers. Most businesses would agree that a territorial tax system could lead to significant tax savings. Nevertheless, accompanying international tax provisions (including those covered below) may mute some of the enthusiasm.

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Tax Existing Overseas Profits: **House:** The House bill imposes a one-time tax rate of 14 percent on companies' existing foreign profits held in cash offshore and 7 percent on their offshore noncash assets. Companies would have up to eight years to pay what they owe. **Senate:** The Senate bill's proposed one-time tax rates on companies' existing foreign profits are slightly higher: 14.49 percent on cash assets and 7.49 percent on non-cash assets held offshore.	This measure is designed to raise tax revenue from income that has not previously been subject to U.S. tax. Under current law, companies pay U.S. tax only when they bring the money home. But it's also meant to entice companies to invest some of their foreign profits stateside. While tech companies are widely viewed as key beneficiaries of the shift to the territorial tax system because of the large amount of earnings maintained overseas by some of the more prominent members, the toll charge may also disproportionately impact them as well. Both the House and Senate bills feature an assessment of tax on a "deemed" distribution of existing profits, whether or not the amounts are actually distributed. The toll charge is significantly higher than that assessed under Section 965 (which featured an effective tax rate of 5.25 percent), a one-year tax holiday created by the American Jobs Creation Act of 2004. The toll charge is payable over eight years under both bills, with some differences in annual amounts due.
Taxation of Low-Taxed Income and Intangibles: **House:** The House bill requires shareholders to include in their income 50 percent of the "Foreign High Return Amount" (FHRA) of their foreign subsidiaries. The FHRA is income earned by controlled foreign corporations (CFC) in excess of a specified routine return on tangible assets. A foreign tax credit equal to 80 percent of the amount attributable to this excess is permitted. **Senate:** The Senate bill requires inclusion by shareholders of Global Intangible Low-Taxed Income (GILTI), which is similar in concept to the FHRA above. However, there are differences in the way in which the excess is computed, and rather than being imposed on 50 percent of the excess, the bill introduces a deduction equal to 50 percent that decreases down to 37.5 percent after 2025. The bill also permits a deduction for foreign-derived intangible income (below).	Tech companies with foreign subsidiaries in low-tax jurisdictions appear to be prime targets for this legislation. While the territorial income provision is the carrot, these provisions are the stick to get U.S. companies to domesticate their high value activities, or at least to permit the U.S. to monetize some of those activities located in low-tax jurisdictions.
Offer a Deduction for Foreign-Derived Intangible Income (Senate): The Senate bill permits an additional deduction against profits of a U.S. shareholder derived from foreign-derived intangible income, as an offset to GILTI. The deduction is initially 37.5 percent of the foreign derived intangible income, which is the U.S. shareholder's excess return associated with export sales of property or services.	This provision effectively taxes such income at a 12.5 percent tax rate. Some commentators have described this as being similar to a "patent box," which is featured in the tax framework of some European countries to encourage the formation of intellectual property within those respective countries, and provides a preferential tax rate on certain income.

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Change Taxation of Foreign-Related Party Transactions: **House:** The House bill imposes a 20 percent excise tax on payments to related foreign parties that are part of the same international financial reporting group. It also applies to partnerships and branches. Specified amounts include amounts allowable by the payor as a deduction, or includible in the cost of goods sold (COGS) or inventory, or in the basis of a depreciable or amortizable asset. The related party can opt out by electing to treat the income as Effectively Connected Income (ECI). **Senate:** The Senate bill requires payment of 10 percent of a company's modified taxable income over its regular tax liability. The tax rate increases to 12.5 percent for taxable years after 2025. This is applicable to a C corporation with gross receipts of $500 million or more, and a "base erosion percentage" of 4 percent or more for that taxable year. Base erosion payments are those that are amounts paid or accrued to a foreign related party, but importantly, does not include amounts includible in COGS. The base erosion percentage represents the base erosion payments as a percentage of total deductions.	The House provision could have a significant impact on technology companies that depend on overseas related parties as a key part of their supply chain, and could force companies to evaluate ways to restructure their operations and flows to mitigate the proposed taxes. The election to treat income as ECI could be a widely considered option.
Limitations on Interest Deductibility: **House:** Revises Section 163(j) and expands its applicability to every business, including partnerships. Generally limits deduction of interest expense to interest income plus 30 percent of adjusted taxable income (an EBITDA-like measure). Disallowed interest may be carried over for five years. Contains a small business exception. **Senate:** Similar to the House provision with the notable differences that adjusted taxable income is essentially an EBIT measurement, and disallowed interest is carried forward indefinitely.	Interest expense ceiling could be problematic to many tech companies, especially with the relatively short five year carryforward period in the House version. The impact of the two proposals will also be dramatically different for some tech companies due to the differences in the definition of adjusted taxable income.
Limitation on Interest Deductions of International Financial Reporting Groups: **House:** Would impose a ceiling on U.S. corporations which are members of large (>$100 million average annual gross receipts over a three year period) international financial reporting groups. The proposal would limit U.S. members from deducting more than a proportionate share of worldwide interest expense, based on worldwide EBITDA, multiplied by 110 percent. Interest expense limitation is the lower of this or that computed under 163(j) (above). **Senate:** Similar to the House proposal. Applied to members of worldwide affiliated groups, but proportionate share is based on a debt-to-equity differential percentage of the worldwide affiliated group, and multiplied by 130 percent (reduced down to 110 percent in years 2022 and forward).	See comment above. These provisions could also impact tech companies in dramatically different ways because of the use of EBITDA in the House version, and a debt-to-equity ratio concept used in the Senate bill.

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Require Amortization of Research & Experimental Expenditures (House & Senate): Both bills will require research and experimental (R&E) expenditures to be capitalized and amortized over a five-year period. The inclusion of software development costs in this category is codified. This is effective for tax years beginning after 2022 under the House bill and after 2025 under the Senate bill.	While much fanfare was given to the fact that the R&E credit would be preserved under both versions of the tax legislation, little was said about this provision, perhaps due to the delayed effective date.
Change Taxation for Employee Fringe Benefits: **House:** Among items no longer excludable from employee wages include: moving expense reimbursements, employer-provided dependent care assistance, and employer-provided educational assistance. The House bill also limits exclusion for employer-provided lodging to $50,000. Items no longer deductible, unless includible in W-2, include: certain moving expense deductions, employer-paid parking, mass transit, van pooling and other qualified transportation benefits, entertainment expenses, amounts in excess of imputed income for cafeterias, and dependent care facilities. **Senate:** The Senate bill includes similar non-deductibility provisions as the House proposal. In addition, it disallows deduction for meals provided for the convenience of the employer on the employer's business premises (effective after 2025).	Tech companies have been at the forefront of offering employees "friendly" working environments and amenities. Elimination of non-taxable fringe benefits and the denial of the deduction for such items will make companies face the decision of ceasing to offer those benefits or to absorb the imputed tax cost of continuing.
Add $1 Million Deduction Limitation on Executive Compensation (House & Senate): Both the House and Senate bills add the CFO to the definition of "covered employees." The proposals eliminate the exception for commissions and performance-based compensation, including stock options. These amounts are currently not subject to the limitation.	For many public tech companies, the exclusion applicable to performance-based compensation provides significant tax relief from the impact of Section 162(m).

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Qualified Equity Grants (House): The House bill permits an election to be made by a recipient of qualified stock that is not publicly tradeable to be deferred until the earlier of: ▶ The stock is transferable; ▶ The employee becomes an excluded employee; ▶ The first date the stock becomes readily tradable on an established securities market; ▶ Five years after the employee's right to the stock is substantially vested; or ▶ The date on which the employee revokes his or her election. "Qualified stock" is stock received by virtue of the exercise of an option or settlement of a restricted stock unit (RSU). This does not apply to stock appreciation rights (SAR) or restricted stock. This provision is not included in the Senate bill.	If passed, this may come as welcome relief to private tech companies—particularly, startup companies—that otherwise restrict the transferability of their stock. Recipients of equity grants have historically had to remit cash to their employer upon exercise of, e.g., stock options to cover the withholding taxes due upon exercise, even though the underlying stock lacked liquidity. The ability to defer taxation of a stock award until it becomes transferable helps to mitigate some of the risk on the part of the recipient.

LOOKING FORWARD

Many changes are still expected over the next several weeks, as the House and Senate bills undergo reconciliation by the conference committee. Based on the magnitude of the changes proposed thus far, if a final bill is signed before the end of the calendar year as targeted by President Trump, the changes will require significant reassessments of tax positions for financial reporting purposes to be reported in the quarter. U.S. tech companies would be wise to keep abreast of the latest developments to avoid the risk of being unprepared.

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