INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

TAX REFORM FAQ FOR TECH COMPANIES

The $1.5 trillion tax reform legislation known as the "Tax Cuts and Jobs Act" (TCJA) represents the biggest change to the tax code since 1986. While the implications for businesses are broad and complex, we've summarized some of the most relevant tax reform questions for tech companies:

HOW WILL THE CORPORATE TAX RATE REDUCTION IMPACT MY CHOICE OF ENTITY?

Insofar as many tech companies (including most of the tech giants) are "C corporations" for tax purposes, the reduced tax rate of 21 percent from 35 percent is a big win for the industry. The law also contains a deduction of up to 20 percent of qualified business income (QBI), which could provide substantial individual tax benefits for startup owners and private tech investors (including private equity), which operate as sole proprietorships or pass-through entities for tax purposes. However, while the tax cuts for C corporations are permanent changes to the Internal Revenue Code, the individual and pass-through (e.g., partnerships and S corporation) provisions are generally phased out in less than a decade. These and other factors, described in part below, could make choice of entity determinations one of the most important tax decisions taxpayers will ever make.

Historically, pass-through entities have been favored by many because they avoid double taxation (i.e., income taxes are imposed at the entity level when earned and a second time when those earnings are distributed to owners, as is the case with C corporations). A lower qualified dividend rate for dividends from C corporations helps to mitigate that situation, but still, pass-through entities were seen as a more attractive vehicle if owners anticipated or desired frequent distributions from the business, or when the owners wished to be positioned to accommodate a future buyer of the business assets (thereby acquiring a stepped-up fair market value tax basis in those assets). Now, even with the available 20-percent deduction for QBI, the new tax law makes the corporate tax rate significantly lower than the tax rate available to pass-through owners, absent a plan to immediately distribute the earnings. That tax rate disparity obliges owners to reconsider and weigh the traditional advantages of pass-throughs against the lower cash tax cost of operating a C corporation.

Beyond tax rates, there are other provisions in the new tax law that may weigh heavily on entity classification decisions. In particular, it has become apparent that some of the new international tax provisions, like Global Low-Taxed Intangible Income (GILTI), are problematic for individuals, including partners in pass-throughs, as discussed below. Further, the new Foreign Derived Intangible Income (FDII) incentive is only available to C corporations. Those that have "checked the box" on foreign subsidiaries to be treated as branches may wish to reconsider in light of the participation exemption available for foreign earnings of controlled foreign corporations ("CFC's"—also see below).

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DOES THE NEW TERRITORIAL TAX SYSTEM MEAN THAT I NEVER HAVE TO PAY U.S. TAXES ON FOREIGN EARNINGS?

Under prior law, U.S. taxpayers were subject to tax on their worldwide income. However, U.S. taxpayers of foreign-regarded subsidiaries (i.e., treated as corporations for U.S. tax purposes) were allowed to defer their foreign earnings until those earnings were distributed back to the U.S. shareholder. Activities which generated "subpart F income," subject to many exceptions, were required to pay U.S. tax on those earnings, regardless of whether the earnings were distributed.

The new tax law was advertised as a territorial tax system, which implies that income earned outside of the United States by a foreign-regarded entity is not subject to U.S. tax when repatriated. The mechanism to achieve this is via a dividends-received deduction, and the only entity eligible for this deduction is a C corporation with a greater than 10-percent interest in the foreign entity. However, the subpart F income regime is still in place, and new categories of subpart F income were introduced, like the GILTI tax (discussed below). To the extent those provisions apply, foreign earnings are still subject to U.S. tax and should be treated as a deemed dividend.

For non-C corporate shareholders, the participation exemption is not available, and they are still subject to the old and new anti-deferral tax regimes. Individuals and non-C corporate entities are largely still taxed on their worldwide income like before.

WHAT SHOULD I KNOW ABOUT THE TAXATION OF GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI)?

The GILTI tax provision may significantly affect tech companies—many of which hold foreign rights to valuable intangibles in low-tax jurisdictions, as well as other profitable activities—through its creation of an unprecedented framework to tax "excess" foreign earnings in CFCs subject to low tax rates. While clearly assessable on operations in what the Treasury refers to as "cash boxes" (i.e., subsidiaries located in countries that impose negligible or no taxes on income), its impact is not limited to intangible income, despite its name. It can be assessed on any foreign activity generating an excess return (roughly defined as income in excess of a 10-percent annual return on depreciable tangible assets). With the availability of an 80 percent indirect foreign tax credit, along with a deduction permitted to C corporation owners equal to 50 percent of the excess return, an incremental GILTI tax levy may theoretically only apply to operations subject to a foreign tax rate of less than 13.125 percent if you are a C corporation shareholder. A scheduled decrease in the 50 percent deduction to 37.5 percent will make that threshold 16.406 percent after 2025. ("Indirect" foreign tax credit refers to foreign income taxes paid by the foreign subsidiary itself, and not directly by the U.S. shareholder.)

The GILTI tax may be especially problematic and expensive for individuals who own CFCs, either directly or indirectly through pass-throughs. That is because the GILTI tax is assessed at the higher individual tax rate, and there is no 50-percent deduction available against the excess return, nor indirect foreign tax credit relief.

In enacting the GILTI tax, Congress undoubtedly expects many tech companies to consider bringing back their high-value operations to the United States. Alternatively, it could also mean that many may simply move these operations from "cash box" countries to other higher tax foreign jurisdictions in light of other business reasons and the diminished tax advantages. Some commentators have even suggested that contrary to the aims of the legislation, the GILTI may actually result in the offshoring of low-return activities to mitigate the tax, frustrating the provision's intent.

ARE THERE ANY OTHER EXPORT INCENTIVES IN THE NEW TAX LAW?

The FDII incentive is a complimentary feature to the GILTI, in that it provides a lower tax rate on deemed intangible income (similar in concept to excess returns used for the computation of GILTI) generated by U.S. corporations, and associated with certain types of income derived from foreign customers. The beneficial tax rate is achieved by offering a 37.5 percent deduction applied to the excess return. This deduction enables FDII to be taxable at an effective tax rate of 13.125 percent (increasing to 16.406 percent after 2025).

To qualify for the deduction, taxpayers generally must sell, lease, license, exchange, or dispose of property to a non-U.S. person for foreign use or provide services that the taxpayer establishes are provided to any person, or, with respect to property, not located in the United States. While there are some computational similarities between the FDII deduction and the repealed Section 199 manufacturing deduction, there are several key differences where the FDII deduction could be broader in scope for many taxpayers than the prior incentives. Unlike Section 199, taxpayers do not need to manufacture the property themselves within the United States to qualify for the FDII deduction; as such, resellers that sell property to foreign parties may be eligible for the benefit. Additionally, service providers that have historically been excluded from Section 199 may be able to take advantage of the FDII deduction as well. As currently drafted, the statutory language governing FDII is fairly expansive.

The combination of the punitive GILTI provisions and the tax-favored FDII treatment has led tech companies to consider maintaining valuable intellectual property and other functions in the United States, as was intended. This is an attractive alternative particularly for small and middle market companies that may have a hard time maintaining duplicative infrastructure overseas.

HOW WILL THE LIMITATIONS ON INTEREST DEDUCTIBILITY AFFECT ME?

The TJCA revises Section 163(j) and expands its applicability to every business, including partnerships. The provision generally caps deduction of interest expense to interest income plus 30 percent of adjusted taxable income, which is computed without regard to net operating losses, business interest income or expense, deductions allowable for depreciation, amortization, or depletion, and certain other items. Disallowed interest is carried forward indefinitely, with a small business exception. Adjusted taxable income will be computed to not be modified for depreciation and interest after 2021, making the limitation even more severe.

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The Section 163(j) ceiling limitation on deductible interest expense may have significant repercussions for tech companies beyond tax liability, which will only become more profound should interest rates rise. The limitation, with its negative impact on after-tax cash flow, could potentially affect valuations and lead companies to more vigorously pursue equity investments or IPOs in the year(s) ahead.

WHAT IS THE BASE EROSION ANTI-ABUSE TAX (BEAT)?

The BEAT seeks to discourage earnings stripping out of U.S. activities by foreign-related parties by applying an additional tax charge to domestic corporations that are members of an international group that has at least $500 million of U.S. gross receipts (average over three years) and a base erosion percentage of three percent or higher for the tax year.

Base erosion payments are amounts paid to a foreign-related (25-percent owned) party that are deductible payments. The base erosion percentage broadly represents base erosion payments made to related parties divided by total allowable deductions for the tax year. Where this exceeds three percent, the company must calculate its modified taxable income for the year—broadly taxable income with the base erosion deductible payments added back.

Payments for inventory, which are includible in the cost of goods sold, are generally not considered base erosion payments. Common types of payments which tech companies might pay to related parties include royalties, interest, R&D payments (including cost-sharing payments), and cost-plus remunerations.

The BEAT tax amount will be 5 percent (rising to 10 percent from 2019 to 2024 and 12.5 percent from 2025) of a company's modified taxable income less the company's regular tax liability for the year (after credits).

HOW MIGHT I BE IMPACTED BY THE CHANGES TO NET OPERATING LOSSES (NOLS)?

Under the TJCA, the use of NOLs is limited to 80 percent of taxable income for losses arising in tax years beginning after 2017. In addition, NOLs can be carried forward indefinitely (they will no longer have an expiration period) but can no longer be carried back. Meanwhile, NOLs arising before Dec. 31, 2017 may still be used in full.

Because of these changes, tech companies will need to separately track their NOLs before and after Dec. 31, 2017. They should also be aware of how the provision may affect them: In situations where tech company earnings are volatile, the restrictions on the carryback and use of NOLs could present a significant cash flow obstacle by further limiting their ability to monetize their tax losses.

HOW DOES TAX REFORM AFFECT EXECUTIVE COMPENSATION?

Under prior law, a publicly held corporation generally could not deduct more than $1 million of compensation in a taxable year for each "covered employee," unless the pay was excepted from this limit. Covered employees included the corporation's CEO at the close of the taxable year, as well as the three most highly compensated employees for the taxable year (other than the CEO or CFO) whose compensation is reported to shareholders. Certain types of remuneration were not subject to the deduction limitation, including performance-based compensation, commissions, and post-termination payments (such as severance and non-qualified deferred compensation paid when the individual was no longer a covered employee).

The TCJA enlarges the types of compensation that are subject to the $1 million deduction limit by repealing the performance-based compensation and commissions exceptions (with grandfathering rules for written binding contracts in effect on Nov. 2, 2017). It also expands the definition of "covered employees" to include: (i) any person serving as the CEO or CFO at any time during the taxable year; and (ii) the three highest compensated officers for the tax year (other than the CEO and CFO) whose compensation is reported to shareholders. Under the TCJA's "eternal covered employee" rule, an individual permanently remains a covered employee, and the $1 million deduction limit applies to all future payments to such individual (even after his or her termination of employment) and to the individual's beneficiaries. Whereas Section 162(m) previously applied to companies with publicly traded equity, the TCJA expanded its application to also cover companies with publicly traded debt and foreign companies traded through American depositary receipts (ADRs).

Executive compensation plan design strategies of the past have limited utility in this tax reform era. While pay-for-performance plans continue to serve other purposes, they can no longer be used to claim deductions for compensation over $1 million paid to a covered employee in a year (unless the grandfather exception applies). The strategy of deferring compensation until the individual ceases to be a covered employee is no longer effective under the eternal covered employee rule. Tech companies should speak with tax advisers to reconsider their current executive compensation arrangements and maximize tax deductions.

WHAT ARE THE LONGER-TERM EFFECTS OF TAX REFORM FOR THE TECH INDUSTRY?

While there are exceptions, many tech companies anticipate tax reform will have a positive long-term effect on the industry. Lower tax rates will provide many companies the capital they need to invest in capital improvements, hiring and retention, expansion, acquisitions, and more. The law's implementation of the participation exemption and FDII makes the United States a more attractive base for tech companies, while provisions like GILTI may cause companies to reconsider their traditional tax planning structures. Doubtless, the tax code changes will significantly weigh on decisions involving tech companies' supply chains, the location of intangibles, site selection, and accounting and financial reporting, among other factors.

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