INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

TAX REFORM'S IMPACT ON THE TECHNOLOGY INDUSTRY

On December 22, just a few weeks following the passage of the Senate's Tax Cuts and Jobs Act, the conference version of the bill was signed into law, marking it the largest change to U.S. tax policy in decades.

WHAT CHANGES ARE COMING FOR TECHNOLOGY ORGANIZATIONS?

To help organizations navigate the issues most impactful and urgent to the technology industry, we've updated our **previous summary analysis** of the key provisions and their industry implications based on the signed legislation.

WHAT SHOULD YOU DO NOW?

Here are five steps technology companies should take now to tackle tax reform:

1. **Assess impact.** Tax professionals will likely need to review the bill text manually and measure their organization's specific circumstances against it to assess the impact of each provision and their holistic effect on their bottom line.

2. **Assemble a team.** While the heaviest burden may fall on accountants, companies and their finance teams will have an important role to play in gathering all the necessary data.

3. **Dig into the data.** Assessing the impact of tax reform requires a substantial amount of data. Organizations need to move from modeling the impact of tax reform to focus on data collection and computations as soon as possible. If you have an international presence, bear in mind that some of the information needed could date back to 1987.

4. **Establish priorities.** When considering what next steps to take, focus on the areas that could have the greatest impact on your organization.

5. **Initiate tax reform conversations with your tax advisor.** Tax reform of this magnitude is the biggest change we've seen in a generation, and will require intense focus to understand not only how the changes apply at the federal level, but also to navigate the ripple effect this is likely to have on state taxation as well.

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Key Provisions for the Tech Industry

PROVISION	SUMMARY OF CHANGES	CONSIDERATIONS FOR TECH COMPANIES
Reduce the Corporate Tax Rate	Last minute changes during reconciliation caused the corporate tax rate to ease up to 21 percent. The previous top corporate tax rate was 35 percent. **Effective date:** Effective for taxable years beginning after Dec. 31, 2017	**Industry View:** Positive ***Comments:*** A reduction in the corporate tax rate is a boon to tech companies overall. For most companies, the benefits of this reduction outweigh the concerns expressed with other parts of the new tax law. While most tech giants are publicly traded C corporations, many others are organized as partnerships or S corporations ("pass-throughs"), with the number of private equity-backed portfolio companies definitely trending in that direction. The new tax law attempts to maintain a reasonably comparable tax rate for pass-throughs by providing a 20 percent deduction against trade or business income. With a top individual tax rate of 37 percent, that still results in a modified tax rate of 29.6 percent. Combined with a $10,000 ceiling on deductible state and local income taxes applicable to individual partners and S corporation shareholders, many companies will want to weigh the benefits of the lower rate versus a potentially better result in the event of distributions or exit offered by pass-throughs (whose single level of tax better facilitates an asset sale).
Repeal the Corporate Alternative Minimum Tax (AMT)	Conforming to the repeal of the corporate AMT, the bill also repeals the election to accelerate AMT credits in lieu of bonus depreciation. **Effective Date:** Effective for taxable years after Dec. 31, 2017	**Industry View:** Positive ***Comments:*** Keeping the corporate AMT (as was proposed in the Senate bill) without a corresponding reduction in the AMT rate would have made it difficult for businesses to reduce their effective corporate tax rate lower than 21 percent. Much concern was expressed that the situation would have largely made other incentives, like the research and development (R&D) credit, irrelevant.
Eliminate Ability to Carryback Net Operating Losses	This change will generally eliminate taxpayers' abilities to carryback net operating losses (NOL), and will limit the use of NOLs to 80 percent of taxable income. NOLs will no longer have an expiration period. **Effective date:** Effective for losses arising in taxable years after Dec. 31, 2017	**Industry View:** Negative ***Comments:*** In situations where tech company earnings are volatile, the restrictions on the carryback and use of NOLs could present a significant cash flow obstacle and hamstring emerging companies (in addition to the "start-up" and enacted research expenditure capitalization provisions).

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Research and Experimentation (R&E) Tax Deduction	Companies will be required to write off research expenses over a longer time period. **Effective date:** Effective for taxable years after Dec. 31, 2021	**Industry View:** Negative ***Comments:*** Taxpayers will eventually not be permitted to immediately expense costs in the year incurred and instead will be required to write off costs associated with R&D over a longer time period. Under current law, taxpayers have the choice of taking an immediate deduction or capitalizing the amounts and amortizing over five years; going forward, the new bill will make capitalization and amortization mandatory. The research credit was emphatically left untouched throughout the recent legislative process and remains a permanent fixture in the Internal Revenue Code. In combination with other changes (including repeal of corporate AMT), the utility of the R&E credit is greatly increased, and its relative value against a 21 percent tax (vs. a 35 percent tax) is enhanced. However, the new tax law's requirement that research expenditures eventually be capitalized and amortized over between five and 15 years will have a huge impact on the tax position of tech companies heavily invested in those activities.
Repeal the Domestic Activities Deduction (DPAD)	The Domestic Activities Deduction (DPAD) was originally enacted to encourage manufacturing within the U.S. **Effective date:** Effective for taxable years beginning after Dec. 31, 2017	**Industry View:** Negative ***Comments:*** The DPAD was originally enacted as a World Trade Organization (WTO)-compliant alternative to export incentives like the Foreign Sales Corporation (FSC) and extraterritorial income (ETI) exclusion. The elimination of the DPAD corresponds with the advent of a favorable rate for foreign-derived intangible income (see below).
Create a Quasi -Territorial Tax System	Modifies the U.S. worldwide taxation system wherein earnings of foreign subsidiaries are generally not taxable until they are distributed as a dividend to U.S. shareholders or included into taxable income under U.S. anti-deferral provisions (e.g., subpart F income). The "exemption tax system" introduced in the tax bill features a participation exemption for dividends received by domestic C corporations from certain foreign subsidiaries to promote the tax-free repatriation of earnings from foreign subsidiaries. However, other features of the worldwide tax system (e.g., subpart F, Section 956, and income earned through foreign partnerships and branches) remain in place. **Effective date:** Effective for distributions made after Dec. 31, 2017	**Industry View:** Positive ***Comments:*** The participation exemption removes the main obstacle behind repatriation of cash from foreign subsidiaries. However, as this does not create a pure territorial tax system, international tax planning will remain as challenging as ever. The new system established by the new tax law may encourage certain companies to bring back earnings from their foreign subsidiaries. However, while some tech giants may have excess cash overseas, many tech companies will need to continue to maintain working capital abroad to grow their businesses there. Companies may consider a more widespread use of outbound loans to fund those needs but will then need to consider local thin capitalization rules and withholding tax levies, as well as currency restrictions.

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Transition Tax on Existing Overseas Profits	Imposes a one-time tax on U.S. shareholders on the accumulated, untaxed earnings and profits of controlled foreign corporations (CFC) and certain foreign corporations wherein a domestic corporation owns at least 10 percent, at a rate of 15.5 percent on the foreign corporations' earnings held in cash and cash equivalent assets and an 8 percent rate on earnings attributable to non-cash assets, regardless of whether or not the amounts are actually distributed. An election may be made to pay the tax over eight years, using a backloaded installment schedule. **Effective date:** Effective for the last taxable year of a foreign corporation that begins before Jan. 1, 2018, and with respect to U.S. shareholders, for the taxable years in which or with which such taxable years of the foreign corporations end. Earnings and profits (E&P) generally determined as of Nov. 2, 2017 or Dec. 31, 2017, whichever is higher.	**Industry View:** Mixed ***Comments:*** This measure is designed to raise tax revenue from income that has not previously been subject to U.S. tax. But it's also meant to entice companies to invest some of their foreign profits stateside. To help get the bill over the line during reconciliation, the rate of tax was increased from that proposed in both Houses. The effective tax rate is significantly higher than it was when the American Jobs Creation Act of 2004 temporarily created the last tax holiday on the repatriation of foreign earnings at an effective tax rate of 5.25 percent. 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.
Taxation of Global Intangible Low-Taxed Income (GILTI)	Requires U.S. shareholders of any CFC to include in gross income for a taxable year its "global intangible low-taxed income" in a manner generally similar to inclusions of subpart F income (complex calculation). Intangible income is determined as the amount earned in excess of a statutorily-defined routine return. Includes special rules relating to determining indirect foreign tax credits on GILTI. Domestic C corporations (other than regulated investment companies (RICs) or real estate investment trusts (REITs)) are generally permitted a partial deduction for GILTI and the section 78 gross up attributable to such amounts. **Effective date:** Effective for taxable years of foreign corporations beginning after Dec. 31, 2017 and to taxable years of U.S. shareholders in which or with which such taxable years end.	**Industry View:** Negative ***Comments:*** While nominally assessed on "intangible income," the law is broad enough to potentially attach to any profitable activity conducted overseas. This provision may be intended to encourage companies to onshore these profitable activities back to the U.S. This provision was almost certainly created with large tech companies in mind, many of which hold foreign rights to valuable intangibles in low tax jurisdictions. The GILTI provision creates an unprecedented framework to tax foreign earnings in such structures and may signal an increasing aggressiveness by the government to monetize activities previously outside its reach and its dissatisfaction with traditional transfer pricing rules. The GILTI tax is an entirely new provision. 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 on other activities conducted in jurisdictions that impose taxes may be negligible, at least with regards to certain corporations. With the availability of an 80 percent foreign tax credit (along with the partial deduction permitted to certain corporations), an incremental GILTI tax levy may theoretically only apply to operations subject to a tax rate of less than 13.125 percent, assuming the U.S. corporation can fully utilize available foreign tax credits. A scheduled increase in the effective GILTI tax rate will make that 16.406 percent after 2025. The GILTI tax may ultimately prompt many tech companies to consider bringing back their high value operations to the U.S., or alternatively, move these operations from "cash box" countries to other foreign jurisdictions. Some commentators have 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 intention of the provision.

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Foreign-Derived Intangible Income (FDII)	Creates a deduction based on excess returns from associated sales and services sold to foreign parties earned by U.S. taxpayers, and results in effective taxation of such income at a 13.125 percent tax rate subject to an increase for tax years after 2025. **Effective date:** Effective for taxable years beginning after Dec. 31, 2017	**Industry View:** Positive ***Comments:*** The FDII has been compared to the patent and intellectual property boxes deployed elsewhere in the world. Foreign-derived deduction eligible income, which generally consists of sales (including license and royalty income) and services provided to foreign customers (subject to certain exceptions), is available as an offset against GILTI and as a deduction effectively reducing the income tax rate on this type of income. It will initially be taxed at an effective rate of 13.125 percent and increase to 16.406 percent after 2025. Tech companies should identify ways to isolate and track this income, as well as the other components necessary to compute the FDII benefit. However, there is concern that, like other U.S. export incentives that preceded it, the provision may eventually be challenged in world trade courts.
Base Erosion Anti-Abuse Tax (BEAT)	Requires certain corporations to pay additional corporate tax in situations where corporations have certain "base erosion payments" to foreign related parties and certain thresholds and conditions are satisfied (complicated formula for determining the tax). This is applicable to a C corporation (other than RICs and REITs) with annual average gross receipts of $500 million or more (three-year testing period) and a "base erosion percentage" of 3 percent or more for that taxable year. Base erosion payments include, among other items, payments that are deductible amounts paid or accrued to a foreign related party. The base erosion percentage represents the base erosion tax benefits as a percentage of total deductions with certain adjustments. **Effective date:** Applies to base erosion payments paid or accrued in a taxable year beginning after Dec. 31, 2017.	**Industry View:** Negative ***Comments:*** The provision seeks to discourage earnings stripping out of U.S. activities, and BEATs out (somebody had to say it) the House proposal, which featured a 20 percent excise tax imposed on payments to related parties, including payments for cost of goods sold (not included as an adjustment for modified taxable income under BEAT except in certain situations dealing with expatriated or inverted groups). The latter could have been extremely onerous, especially for tech companies with related party manufacturing outside the U.S.
Limitations on Interest Deductibility	Revises Section 163(j) and expands its applicability to every business, including partnerships. Generally caps deduction of interest expense to interest income plus 30 percent of adjusted taxable income, which is computed without regard to deductions allowable for depreciation, amortization, or depletion. Disallowed interest is carried forward indefinitely. Contains a small business exception. **Effective date:** Effective for taxable years beginning after Dec. 31, 2017	**Industry View:** Negative ***Comments:*** The Section 163(j) ceiling limitation on deductible interest expense will have a dramatic impact on many tech companies, with significant repercussions beyond tax liability. These impacts will only become more profound should interest rates rise. The limitation, with its negative impact on cash flow, could potentially affect valuations. Will this mean companies will more vigorously pursue equity investments, or even result in more industry IPO activity?
Taxation for Employee Fringe Benefits	Disallows deductions related to employee perks, including activities considered to be entertainment, amusement or recreation, and transportation benefits. **Effective date:** Effective taxable years after Dec. 31, 2017 Disallowance of deduction for meals provided for the convenience of the employer on the employer's business premises is effective after 2025.	**Industry View:** Negative ***Comments:*** Tech companies have been at the forefront of offering employees "friendly" working environments and amenities. The denial of the deduction for such items will make companies face the decision of ceasing to offer these benefits or absorbing the imputed tax cost of continuing.

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$1 Million Deduction Limitation on Executive Compensation	Adds the CFO to the definition of "covered employees" and eliminates the exception for commissions and performance-based compensation, including stock options, from the definition of compensation subject to the $1 million deduction limitation. **Effective date:** Effective for taxable years beginning Dec. 31, 2017 A transition rule applies to grandfather payments if the right to participate in the plan is included in a written binding contract in effect on Nov. 2, 2017 and which was not modified on or after this date.	**Industry View:** Negative ***Comments:*** For many public tech companies, the exclusion applicable to performance-based compensation provided significant tax relief from the impact of Section 162(m).
Qualified Equity Grants	Permits an election to be made by a recipient of qualified stock that is not publicly tradable 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. **Effective date:** Generally applies with respect to stock attributable to options exercised or RSUs settled after Dec. 31, 2017	**Industry View:** Positive ***Comments:*** This comes as a welcome relief to private tech companies—particularly, startups—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 mitigate some of the risk on the part of the recipient.

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