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A View From Silicon Valley: Tax Reform And The Tech Industry

By **Michele Alexander and Ryan Davis** (March 19, 2018, 3:39 PM EDT)

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The Tax Cuts and Jobs Act, P.L. 115-97, contains a number of provisions that will have consequences for the technology industry, affecting companies' choices about entity classification, where they do business and hold assets, and the manner in which they receive or make investments.

Perhaps the change garnering the most attention is the 40 percent reduction in the corporate tax rate, which was lowered from 35 percent to 21 percent. This lower rate obviously impacts income at the entity level, but it also means that each dollar of income distributed to a corporation's shareholders will be subject to an effective federal income tax rate of 36.8 percent — 21 percent at the entity level and an additional 20 percent at the shareholder level — significantly lower than the pre-TCJA effective rate of 48 percent.[1] This obviously will yield major benefits to technology companies operating as corporations and their shareholders, particularly for smaller companies with primarily domestic operations — and may help offset the disproportionate benefit that the largest companies get from the low repatriation rates discussed below. That said, larger companies benefit greatly from this reduction as well, as evidenced by bonuses distributed by a number of corporations in response to TCJA's passage and other raises and investments that followed. Many technology companies, of course, already operate as C corporations due to their venture capital, or VC, investor base. This type of investor tends to scrupulously avoid pass-through investments, as many have zero tolerance for income effectively connected with a U.S. trade or business, known as effectively connected income or ECI. Most technology companies would cause their owners to incur ECI if operated through a partnership or LLC treated as a partnership for U.S. tax purposes. This affects not just the immediate technology investment, but rather taints the investor with a trade or business that can change the taxation of its other investments, namely those that are otherwise passive. Even domestic VC investors prefer to avoid the relatively minor consequences of being engaged in a technology business, though this view may evolve as this investor space begins feeling the impact of tax reform — including changes to deductibility limits on certain expenses. The new lower rate is a bonus for those who already are operating in corporate form. For other, smaller technology companies that have engaged in long-term planning such as an IPO or Up-C structure, the long-term plan to convert to a corporation may be accelerated to take advantage of lower rates.

Although they will not benefit from the new lower corporate tax rate, technology companies that operate as pass-throughs may also reap the benefit of the new qualified business income, or QBI, deductions. New IRC Section 199A generally permits a 20 percent deduction against taxable income for QBI that is taxable income earned from certain U.S. trades or businesses. Under prior law, an individual taxpayer's QBI would have been subject to the ordinary federal income tax rates applicable to individuals, with a maximum rate of 39.6 percent. Under TCJA, unless limitations apply, the QBI deduction could reduce the maximum effective rate imposed on an individual's QBI to 29.6 percent — or 80 percent of the new maximum ordinary rate of 37 percent. This lower rate may make participating as a partner in a partnership — or more likely in this space, as an LLC taxed as a partnership — more attractive, thus leading individuals involved in the technology industry to choose to operate their company as a pass-through rather than a corporation (except to the extent of constraints by their investor base, as noted above). However, the limitations on the QBI deduction may limit the benefit for certain higher-income individuals. Potential partners with taxable income in excess of $415,000 (married filing jointly) or $207,500 (single or filing separately) may be unable to take the QBI deduction, meaning any QBI would be taxed at the maximum ordinary rate of 37 percent. Moreover, both the reduced rates for individuals and the QBI deduction are scheduled to expire at the end of 2025 and, if not extended, the effective C corporation rate discussed above would be lower than the maximum individual rate applicable to pass-through income — 39.6 percent. Taxpayers now choosing to operate their technology-related businesses as pass-throughs may rethink this decision later if both the new individual rates and the QBI deduction expire after Dec. 31, 2025. However, these taxpayers then could benefit from the lower corporate rate, which is not scheduled to expire.

Perhaps more so than other industries, the technology sector has been affected by changes made to the IRC's international provisions. Along with lowering the corporate tax rate, a primary objective of tax reform was transitioning to a so-called territorial system of taxation. To accomplish this policy aim, lawmakers had to focus on certain anti-base erosion measures, to ensure that a territorial tax system did not allow vast amounts of income to escape taxation by remaining abroad. This is particularly true in the case of the technology sector, as the five largest technology companies have approximately $457 billion of assets held in foreign subsidiaries that were not subject to U.S. taxation before TCJA. These assets abroad have garnered headlines in recent years as the result of widely-publicized corporate inversions which were disproportionately utilized by companies holding valuable intangible assets, especially technology companies. Such inversions allowed the value of the company's intangible assets to be attributed to the foreign jurisdiction which was considered the company's post-inversion residence, while allowing it to maintain its significant U.S. operations.

In order to encourage the return of this capital to the U.S., and thus the tax base, TCJA provides for a low one-time repatriation tax on income previously kept abroad in foreign corporations —15.5 percent on foreign cash and other liquid assets and 8 percent on all residual assets, in each case, to the extent of earnings and profits — regardless of whether the related cash or assets actually are distributed. Companies may be more inclined to take advantage of this repatriation opportunity in light of recent EU court decisions which are forcing Amazon and Apple to repay millions in taxes. Corporations subject to the repatriation tax will go on to enjoy the benefits of the new, mostly territorial system by virtue of the new 100 percent dividends received deduction, or DRD, for distributions from a foreign subsidiary to its 10 percent U.S. shareholders. This deduction applies only to the foreign-source portion of dividends received from a foreign corporation by its U.S. corporate shareholders and, as a result, may be another reason for technology companies to consider operating as corporations. Of course, even a 21 percent rate is double taxation, but depending on a company's profits and where such profits are generated, incorporating may be an efficient long-term strategy — especially given the temporary nature of the QBI deduction and noncorporate tax rates.

While the repatriation tax is seen as the cost of switching to a new territorial system, the new base erosion anti-abuse tax, known as BEAT, generally operates to limit deductibility of payments to affiliates of U.S. taxpayers that are in low or no tax jurisdictions. The BEAT generally requires corporations with average annual gross receipts of $500 million to pay a tax equal to 10 percent for years before 2025, with a phase-in at 5 percent for 2018. Notably, the new provision provides an exception for research and development activities. This tax, and this exception, may be highly relevant for technology companies that have research and development activities abroad — particularly in jurisdictions with incentives for this type of development — and that are considering moving activities to the U.S. rather than be adversely impacted by other base erosion measures. In addition, the $500 million threshold for the BEAT may not deter small to midsize technology companies — as they would fall outside the scope of the tax — but still may be a consideration for many large technology corporations as they consider whether to bring these activities back to the U.S. However, aside from the new DRD, TCJA does little by way of positive incentive to bring production activities back onshore. In fact, TCJA repealed Section 199, which provided a deduction for domestic production activities, in what was a major blow to many industries, including technology. Rather than being rewarded for keeping innovation in the U.S., TCJA takes away the most significant tax benefit for U.S. production and manufacturing and focuses instead on negative consequences to convince domestic companies to move their assets and activities back to the United States.

Another new international provision in TCJA designed to impose a tax on companies that hold valuable intangible assets offshore could also (along with a related deduction) encourage repatriation – though likely of assets/activity. The global intangible low-taxed income, or GILTI, tax requires U.S. shareholders holding at least a 10 percent share of a controlled foreign corporation to include in gross income for the tax year such corporation's income from intangible assets held abroad that would not otherwise be taxable in the United States. The new tax applies only where a company's non-U.S. tax bill is below a minimum threshold or where there is excess foreign profit. Although there are deductions available that will allow corporations to be taxed at an effective rate of 10.5 percent through 2025 and at 13.125 percent beginning in 2026, given that this income otherwise would not be taxed until repatriated, it is a liability for technology companies to consider when choosing whether to repatriate offshore assets. Perhaps more significantly, the deduction is not available to non-corporate taxpayers. This may be another new reason to consider converting to or, especially in this industry, to appreciate existing in corporate form. The new GILTI rules are under intense scrutiny for certain potential unintended consequences, so future guidance and regulations that could impact how this provision is interpreted and/or enacted may be forthcoming.

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[1] This does not take into account the deductibility of state and local taxes which is no longer available.