Executive summary

On 22 December 2017, United States (US) President Trump signed the US Tax Cuts and Jobs Act (TCJA) (H.R. 1) into law. This Alert addresses the top issues for technology companies under the TCJA. The technology sector encompasses a broad array of subsectors including semiconductor, computer hardware/peripherals, software/cloud/SaaS (software as a service), and internet/social media companies. Numerous provisions in the new law may impact inbound (foreign owned) and outbound (US) technology companies.

Detailed discussion

US-based manufacturing and R&D

Domestic production activity deduction: The domestic production activities deduction (Section 199) is a deduction computed on qualifying income derived from certain activities performed in the US. This deduction is repealed for tax years beginning after 31 December 2017 (following the House bill’s effective date).
**DISC/IC-DISC**: The TCJA adds Section 951A to prevent the erosion of the US tax base. Under Section 951A(t)(1)(A), global intangible low-taxed income (GILTI) included in gross income under Section 951(a) is treated the same as subpart F income for purposes of determining the qualified export receipts of a DISC/IC-DISC under Section 993(a)(1)(E).

**Research credit**: The research credit available under Section 41 is retained without modification. However, research and experimental (R&E) expenses, as determined under Section 174, must be amortized over five years, with R&E conducted outside the US amortized over 15 years. R&E specifically includes expenses for software development. Amortization is required for expenses incurred in tax years after 2021.

**Impact of US-based manufacturing and research and development (R&D) provisions**: Many technology companies benefit from incentives related to manufacturing and/or R&D that is conducted within the US. This may include semiconductor, computer hardware/peripherals, software/cloud companies that provide software, and companies that develop and provide online software (e.g., SaaS or cloud offerings). These incentives are either being eliminated (Section 199 deduction) or changing as outlined previously. Technology companies that benefited from these incentive regimes should conduct detailed modeling to assess the impact by comparing the loss of the Section 199 against the potential benefits of: (1) the lower 21% corporate tax rate; (2) availability of continued research credits (but note the change later for certain capitalization requirements); and (3) the immediate expensing of qualified property to the extent available. This is a facts-and-circumstances analysis and the specific impact will vary among the technology subsectors as well as companies within the same subsector.

Companies should note that the impact of the law is more of a cash flow and timing issue than an elimination of the research credit, i.e., technology companies will eventually be in the same place as they would have been under existing law, but over an extended period (5 or 15 years).

Calendar- and fiscal-year taxpayers can currently take advantage of the Section 199 deduction for the 2017 tax year. Fiscal-year taxpayers can still claim the Section 199 deduction for qualifying production activities income derived in the fiscal year straddling 2017 and 2018. For the 2018 tax year, equally robust opportunities exist in the form of look-back studies for open tax years.

**International provisions**

Similar to the House and Senate bills, the TCJA includes major proposals that affect the US international tax system including:

1. imposing a transition tax on accumulated foreign earnings;
2. implementing a dividend exemption system (in effect, a partial territorial tax system);
3. imposing current taxation on certain intangible property returns;
4. creating a new inbound base erosion tax; and
5. new transfer pricing methodologies that apply to IP alignment strategies. Each of these rules is discussed briefly next as well as a summary of the impact to the technology sector.

**Transition tax**: The TCJA provides a one-time transition tax on a US 10%-shareholder’s pro rata share of the foreign corporation’s post-1986 tax-deferred earnings, at the rate of either 15.5% (for accumulated earnings held in cash, cash equivalents or certain other short-term assets) or 8% (for accumulated earnings invested in illiquid assets (e.g., property, plant and equipment). A foreign corporation’s post-1986 tax-deferred earnings are the greater of the earnings as of 2 November 2017 or 31 December 2017. The portion of post-1986 earning and profits subject to the transition tax does not include earnings and profits that were accumulated by a foreign company before attaining its status as a specified foreign corporation (that is, a foreign corporation with a US shareholder). Similar to both the House and Senate bills, the law allows post-1986 accumulated earnings deficits of any foreign corporation (that is, a foreign corporation with a US shareholder). Similar to both the House and Senate bills, the law allows post-1986 accumulated earnings deficits of any foreign corporation to offset tax-deferred earnings of other foreign corporations. The law also adopts the House provision that allows the netting to generally be done among all affiliated group members. The US shareholder may elect to pay the transition tax over a period of up to eight years.

Other provisions of note include:

- The Treasury is authorized to provide guidance in order to avoid double counting and double non-counting of earnings.
- The Statement of Managers also noted that the conferees are aware that taxpayers may have engaged in “tax strategies designed to reduce the amount of post-1986 earnings and profits (E&P) in order decrease the amount of the inclusion required under the provision,” and thus provides the Treasury with authority to issue guidance to adjust earnings in those cases.
- For companies expatriate or invert during the 10-year period after the date of enactment, the law adopts the Senate provision imposing a full 35% deemed repatriation tax, without the benefit of foreign tax credit offset.
100% exemption for foreign-source dividends: The TCJA generally follows the Senate bill with some exceptions. It exempts 100% of the foreign-source portion of dividends received by a US corporation from a foreign corporation (other than a Passive Foreign Investment Company that is not also a Controlled Foreign Corporation (CFC)) in which the US corporation owns at least a 10% stake. Some particular provisions to note:

- A holding period of more than one year in the stock of the foreign corporation is required.
- No exemption for any dividend received by a US shareholder from a CFC is allowed if the dividend is deductible by the foreign corporation when computing its taxes.
- No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any portion of a distribution treated as a dividend that qualifies as a dividends received deduction.
- Special rules for the sale of foreign corporations – The TCJA applies the dividend exemption to the gain from the sale of foreign stock, to the extent of its E&P, and clarifies that the dividend exemption applies to the gain from the sale of lower-tier CFCs to the extent of the CFC’s E&P. A US parent reduces its basis in the stock of the foreign corporation equal to the amount of any exempt dividend it received from that foreign corporation only for determining loss on the sale of stock of a 10%-owned foreign corporation.
- Section 367(a)(5) active trade or business exception repealed – Transfers of property used in an active trade or business no longer qualify as an exception to the current rule that prevents such transfers from qualifying as tax-free organizations, reorganizations, or liquidations. The exception is removed for transfers after 2017.
- The TCJA allows an exemption for a US corporation’s distributive share of a dividend received by a partnership in which the US corporation is a partner if the dividend would have been eligible for the exemption had the US corporation directly owned stock in the foreign corporation.
- The effective date is generally for distributions made after 31 December 2017.

Taxation of intangible property returns: The TCJA contains the following provisions, which are similar to the Senate bill, on the taxation of intangible property returns:

- “The Stick” – The new law imposes a tax on a US shareholder’s aggregate net CFC income that is treated as GILTI. GILTI is gross income in excess of extraordinary returns from tangible depreciable assets, excluding effectively connected income (ECI), subpart F income, high-taxed income, dividends from related parties, and foreign oil and gas extraction income. The extraordinary return base equals 10% of the CFCs’ aggregate adjusted basis in depreciable tangible property. Only 80% of the foreign taxes paid on the income are allowed as a foreign tax credit. All CFCs are aggregated for purposes of the computation. For tax years beginning after 31 December 2017 and before 1 January 2026, the highest effective tax rate on GILTI is 10.5%. For tax years beginning after 31 December 2025, the effective tax rate on GILTI is 13.125%.
- “The Carrot” – The new law maintains the tax incentive in the Senate bill for US companies to earn intangible income from US intangibles abroad. Income from foreign derived intangible income (FDII) for tax years beginning after 31 December 2017 and before 1 January 2026 is provided an effective tax rate of 13.125%. For tax years beginning after 31 December 2025, the effective tax rate on FDII is 16.406%. Eligible income does not include, among other items, financial services income under Section 904(d)(2)(D).
- The new law drops special rules for transfers of intangible property to the US – A Senate bill provision would have allowed US companies to repatriate their intangible property tax-free over three years.

Inbound base erosion tax: The TCJA adopts the Senate bill’s new base erosion anti-abuse tax (BEAT) provision. The BEAT applies to corporations (other than RICs, REITs, or S-corporations) that are subject to US net income tax with average annual gross receipts of at least US$1 500 million and that have made related-party deductible payments totaling 3% (2% for banks and certain security dealers) or more of the corporation’s total deductions for the year. A corporation subject to the tax generally determines the amount of tax owed under the provision (if any) by adding back to its adjusted taxable income for the year all deductible payments made to a foreign affiliate (base erosion payments) for the year (modified taxable income). Base erosion payments do not include cost of goods sold, certain amounts paid with respect to services, and certain qualified derivative payments. Regarding outbound services payments, such payments do not constitute base erosion payments if such services meet the requirements for eligibility for use of the services cost method under Section 482, determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure and such amount constitutes the total services cost with no markup. The excess of 10% (5%
in the case of one tax year for base erosion payments paid or accrued in tax years beginning after 31 December 2017) of the corporation's modified taxable income over its regular tax liability for the year (net of an adjusted amount of tax credits allowed) is the base erosion minimum tax amount that is owed. For tax years beginning after 31 December 2025 the rate increases from 10% to 12.5%.

**Transfer pricing and intangible property transfers:**

Workforce in place, goodwill (both foreign and domestic), and going concern value are considered to be intangible property within the meaning of Section 936(h)(x)(B). Further, the law states that the Secretary shall have the authority to specify which method must be used to determine the value of intangible property with respect to outbound restructurings of US operations as well as intercompany pricing allocations. This is accomplished through the amendment of Section 482 as well as granting authority under Section 367 to permit the use of aggregate basis valuation and the application of the realistic alternative principle. These rules are effective for tax years beginning after 31 December 2017.

**Impact of international provisions:** As discussed in a previous technology **Global Tax Alert on the House bill**, in regards to tax reform overall, the technology sector was one of the key industries in the middle of the “lock-out” effect or “trapped cash” debate, given its general global success and deferral-oriented international operating profiles. Thus, the impact of any mandatory toll charge on tax-deferred foreign earnings continues to be significant for technology companies, but also directly related to the adoption of a territorial system. The final law includes a higher transition tax rate than either the House or Senate bills, which is a detriment to technology companies with significant untaxed E&P. Given recent enactment in 2017, technology companies should prepare for the transition tax by ensuring earnings and profits/tax pools are up-to-date and accurate, as well as reviewing balance sheets to sort out and identify the cash and non-cash assets. Once this information is confirmed, technology companies should then begin to model out the impact of the transition tax.

As it relates to the new territorial system, technology companies may benefit from the ability to repatriate foreign earnings in a tax-free manner; however, these companies must continue to: (1) manage the existing subpart F (such as foreign personal holding company income, foreign base company sales income, and foreign base company services income, all of which are defined under Section 954) and other anti-deferral provisions (e.g., Section 956, which was not repealed as part of the final law) within their supply chains; and (2) address the new subpart F GILTI provision aimed at taxing foreign intangible returns. The GILTI provision effectively waters down the territoriality effect for most technology companies that are intangible property intensive as the bulk of their income is subject to the 10% minimum US tax. It can be expected that technology companies’ operating models will eventually evolve to reflect the move to a (partial) territorial system of taxation and the lower rates of US federal tax on GILTI and FDII income (compared to the new 21% corporate rate), while also balancing the need to have international operating substance in place to serve foreign customers and effectively compete in international markets. Without the tax-efficient option of repatriating intangible property assets to the US, taxpayers will have less flexibility with respect to intangible property ownership. In any event, technology companies will likely continue to prioritize the needs of the business first and continue to operate, acquire and develop significant assets in the markets that are the most relevant to their success.

The TCJA generally follows the Senate bill’s approach towards the taxation of foreign intangible returns in different manners. Technology companies should model out each proposal to quantify the impact. The law does clarify that the FDII (the “carrot” discussed previously) includes royalty income, which may be subject to a reduced effective tax rate of 13.125% for tax years beginning after 31 December 2017 and before 1 January 2026. Should technology companies choose to retain intangible property in the US, then they may benefit from this FDII provision. However, there are many other factors to consider in this regard and technology companies should model the results of alternative scenarios, taking into account both the GILTI and FDII provisions, respectively. At the same time, technology companies should evaluate the impact of the revised transfer pricing rules on any IP-alignment strategies they may be exploring.

As to payments made to related parties outside the US, the new law includes an anti-base erosion tax (the BEAT mentioned earlier). On the positive side, similar to the Senate Bill, the TCJA provides flexibility for technology companies whose supply chain requires them to purchase goods or services (e.g., R&D) from overseas related parties. Regardless, technology companies across all sectors that make deductible payments to related parties should make a point to evaluate their supply chains to determine the impact, as it is generally effective for payments made in tax years beginning after 31 December 2017.
Corporate capitalization

Interest deductions: The TCJA limits the deduction for net interest expense of all businesses by amending Section 163(j). Unlike the House and Senate bills, however, the final law drops the additional interest expense limitation that would have been imposed through a worldwide debt cap under what would have been Section 163(n). The revised Section 163(j) limitation applies to net interest expense that exceeds 30% of adjusted taxable income (ATI). For the first four years, ATI is computed without regard to depreciation, amortization, or depletion. Thereafter (beginning in 2022), ATI is decreased by those items, thus making the computation 30% of net interest expense exceeding EBIT (earnings before interest and taxes). ATI is otherwise defined similar to current Section 163(j). Interest expense must be related to a “business,” which means the interest is properly allocable to a trade or business. Certain activities are excluded from being a trade or business — e.g., performing services as an employee, a real property trade or business, and certain activities of regulated utilities. A small business exception is keyed to businesses satisfying a gross receipts test of $25 million. The provision is effective for tax years after 2017.

Expenses for foreign-source dividends: Similar to the House and Senate Bill, the final law denies deductions that are properly allocable or apportioned to exempt foreign-source dividends.

Corporate capitalization impact: New Section 163(j) will affect highly leveraged technology companies as well as technology companies that traditionally consider the deduction of interest expense to be an important factor in their operating business decisions. Despite the fact that the provision calls for the amendment of Section 163(j), which generally limited interest deductibility for inbound financing arrangements, the provisions on interest deductibility affects both inbound and outbound technology companies. On the other hand, the potential denial of deductions related to foreign-source dividends may make equity financing less attractive than it is today. Thus, technology companies (across all subsectors) should consider a review of their current respective capital structure and future financing needs to confirm the impact of this new provision. Modeling is recommended to determine whether the loss of interest deductions may cause the technology company to be in a net taxable position, which may not have been case under the existing interest deduction rules.

Executive compensation and other deductions

Treatment of qualified equity grants: Qualified employees may elect to defer for income tax purposes the inclusion in income of the amount of income attributable to qualified stock. Qualified stock is stock of a corporation if no stock of the employer corporation is readily tradable on an established securities market and the corporation has a written plan under which not less than 80% of all employees who provide services to the corporation are granted stock options or RSUs. The provision applies to stock attributable to options exercised or RSUs settled after 31 December 2017.

Executive compensation: The TCJA expands the $1 million deduction limit that applies to compensation paid to top executives of publicly traded companies. The law eliminates the performance-based compensation and commissions exceptions to Section 162(m) and expands the definition of covered employee to include the CFO. In addition, it limits the ongoing deductibility of deferred compensation paid to individuals who previously held a covered employee position, even after they no longer hold that position. Thus, once an individual is named as a covered employee, the $1 million deduction limitation applies to compensation paid to that individual at any point in the future, including after the cessation of services. The provision expands the applicability of the deduction limitation to foreign companies that are publicly traded on an American Depositary Receipt and to certain private companies that have publicly traded debt. The provision is effective for tax years beginning after 31 December 2017. However, a transition rule applies to compensation paid pursuant to a written binding contract that is in effect on 2 November 2017 that has not been materially modified.

Employer deductions for fringe benefits: Expenses paid for entertainment activities and membership dues, and employee transportation or commuting expenses will no longer be deductible after 2017. Expenses for meals and beverages continue to be deductible at 50% and are expanded temporarily (until 2026) to cover expenses incurred for food and beverages offered for the employer’s convenience. Employee awards provided in cash or via gift cards do not qualify as an expense eligible for a deduction by the employer.
**Impact of changes to executive compensation and other deductions:** Many start-up technology companies use equity plans to attract, incentivize and retain highly qualified executives and other critical employees (often offering this equity-based compensation in place of outright cash compensation). Technology companies should carefully consider the treatment of qualified equity grants and educate equity recipients on the benefit of the income tax deferral election. In addition, publicly traded technology companies should be aware of the amendment of Section 162(m) provisions that expands the deduction limitations on executive compensation and should be prepared to identify covered employees under the new rules. Finally, many technology companies offer certain fringe benefits (e.g., meals) to employees as a general incentive. Technology companies should review these plans, as well as other expenses (e.g., entertainment, transportation, etc.) to quantify the tax impact, as these expenses may no longer be deductible.

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**Endnotes**

1. Currency references in this Alert are to US$. 
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