Flashpoint
2017’s tax code changes
Thinking through the implications for technology companies
One of the most transformative changes to the corporate US tax code in decades, the Tax Cuts and Jobs Act was signed into law on December 22, 2017.

Not only has the corporate tax rate been reduced from 35 to 21 percent, but a one-time tax on earnings currently held overseas, as well as a shift (at least in name) away from a worldwide tax regime that allowed deferred taxation of foreign profits, is likely to result in an influx of cash back to US corporate headquarters. These changes may have implications for technology companies that extend far beyond their financial results. In fact, we may soon witness a tectonic shift in how US- and non-US-headquartered companies assemble their value chains, in which jurisdictions they choose to perform research and development activities, and where they invest in organic and inorganic expansion.

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About Flashpoints

Every day brings new ideas and possibilities to the Technology, Media, and Telecommunications sectors. Flashpoints is your tool for gaining the context you need to make sense of these critical developments—as they emerge.
Key considerations

Cash repatriation
It is highly likely that many US-based multinational technology companies will start bringing cash home. How they will choose to deploy it is already cause for speculation.

Innovation may get a shot in the arm
A cash influx can open up opportunities for companies to acquire other businesses, technologies, and talent. But will a hot mergers and acquisitions (M&A) market drive up values?

Value chains could be turned inside out
The huge shift in how international income is taxed will likely prompt companies to view their value chains through an entirely new lens.

States may soon be getting into the act
Federal tax changes are also important to states. Anticipate tax-advantaged credits and incentives for companies looking to expand their presence—including foreign enterprises, but states are not required to adopt lower rates to offset the burden on corporate taxpayers of a broader tax base.

Everyone has a role to play
From the CEO to heads of individual business units, every executive will likely feel the impact of these tax changes on their domains. They should be prepared to ask—and answer—the right questions.
Prior to tax reform, most income earned by the foreign subsidiary of a US corporation was not subject to tax until it was brought back to the United States—usually in the form of dividends. This deferred taxation system is what arguably led companies to make investments of cash overseas. Because those past foreign earnings are now subject to immediate US taxation regardless of where they are held, companies will now be able to bring those foreign earnings back tax-free on a go-forward basis.

The question now becomes, what might be the best way to deploy repatriated cash?

Many tech companies are very well capitalized and don't necessarily need a cash infusion. Some have gone on record as saying repatriation will have no impact on their capital allocation plans. It is also possible that many will utilize the cash for stock buybacks, dividends, and repayment of debt or raise wages and/or pay bonuses to employees. In addition, there are other ways to deploy capital that companies should be thinking about, from investing in research and development (R&D), to attracting top talent, to engaging in M&A. Regardless of how this all plays out, the tech world could witness some interesting shifts as a result of 2017’s tax code changes.

One-time transition tax

- Cash and equivalents from foreign subsidiaries taxed at 15.5%
- Non-cash assets taxed at 8%
- Tax can be paid in installments over an eight-year period
- Includes provisions for foreign tax credits
- Earnings and profits determined as of November 2, 2017, or December 31, 2017, whichever is higher
Innovation is typically the life blood of technology companies, and their ability to bring to market a continuing stream of new products and services can depend on both cutting-edge R&D and access to top talent. Some companies may therefore use their newly repatriated cash to shore up internal R&D initiatives. Others may choose to acquire intellectual property (IP) or specific capabilities that can help them secure a more competitive position in the marketplace. While this could lead to a flurry of M&A activity, it is also possible that the flood of money looking for a place to go will drive up valuations.

Tax changes that may impact M&A transactions include the new limit on interest deductions to 30 percent of earnings before interest, taxes, depreciation and amortization (EBITDA) for the next five years, followed by 30 percent of earnings before interest and taxes (EBIT) after that. That's a meaningful change, from an M&A standpoint, because companies often consider the impact of interest deductions when deciding what they are willing to pay in a deal.

Asset deals or stock deals in which a Section 338(h)(10) election is made may also be more attractive given that buyers will have the ability to obtain accelerated depreciation on qualified property. Furthermore, given the new Act's restrictions on utilization of net operating losses (NOLs), companies that have pre-tax-reform NOLs that can be carried back two years and that are eligible to offset 100 percent of taxable income (subject to limitations resulting from ownership changes) may be more attractive to buyers.

The new tax law does include good news for companies that choose to invest in R&D: The R&D tax credit, once thought to be in jeopardy, was retained. However, companies’ ability to take deductions for R&D expenditures will slow down beginning in 2022. At that time, R&D expenses will no longer be deductible as incurred, but instead will be capitalized and amortized over a five-year period. The amortization period will be much longer—for R&D conducted outside the United States, making it more likely that R&D centers might be centralized in the United States (assuming Congress does not revisit this provision before then).

How tax reform may impact innovation and M&A

- Starting in 2022, companies will have to amortize R&D expenses over five years in the US and 15 years overseas.
- Limit on interest deductions: 30% of EBITDA for the next five years; 30% of EBIT beginning in 2022.
- 100% bonus depreciation on properties acquired and placed in service after September 27, 2017, and before January 1, 2027.
- Elimination of two-year carryback of NOLs and limitation of NOL utilization to 80% of taxable income for NOLs arising after December 31, 2017.
Value chains could be turned inside out

Perhaps one of the biggest implications of the new laws is that current operating models may no longer be consistent with operational objectives. In fact, technology companies may need to reevaluate their entire value chain, including where and how they make things and perform services, and whether their intercompany transactions need to be redesigned and reconstructed. This, in turn, could affect decisions about global mobility and real estate, analyses about the cost of doing business in different countries, and whether information technology (IT) systems are able to collect, remit, and report within any global model.

One likely critical decision for technology companies involves their IP, a core source of value. Unlike physical assets, IP is more easy to move and can be licensed to entities in multiple jurisdictions. Consequently, until now, many technology companies have opted to centralize IP ownership outside the United States, where it can lead to operational synergies and cost savings. That may be about to change. US companies will likely see their profits derived by its controlled foreign corporations and other income earned directly attributable to sales and the provision of property outside the United States, taxed at a rate lower than the 21 percent headline rate. In contrast, these US companies may have to contend with a new “minimum” tax system under Base Erosion and Anti-Abuse Tax (BEAT).

The location of software development centers is likely another important decision. In recent years, much of this activity has been taking place overseas in places like India, China, and Eastern Europe. Given the new tax law, tech companies will likely need to think about whether this arrangement still makes sense, or whether it is more appropriate to perform development work closer to US customers—generally the largest or second-largest market for technology offerings.

Foreign companies that for tax reasons have conducted business in the United States as branches, thus limiting their operations here, may want to rethink this strategy. Instead of doing all of their development offshore, setting down roots in the United States and going through the US tax regime could potentially be a more attractive and efficient way of conducting business.

Additional tax reform provisions

Foreign-Derived Intangible Income (FDII)
- 37.5% deduction 2018–2025
- 21.875% deduction starting in 2026

Global Intangible Low-Taxed Income (GILTI)
- GILTI taxed immediately and subject to a 50% deduction through 2025, then 37.5% limited to taxable income

BEAT
- 10% (5% in 2018) new “minimum tax” system
States may soon be getting into the act

If companies decide to bring back more of their operations to the United States, finding the optimal location involves a number of considerations. Companies should take a close look at the general impact of doing business in a particular state, as well as the potential state-by-state implications of federal tax provisions. For instance, some states may tax repatriated earnings (deemed or actual) while others may not; some may apply different rules for calculating interest limitations; and some may apply different apportionment methodologies.

Ultimately much of the location decision may come down to what sort of credits and incentives states will be offering. States that are hungry for well-paying jobs that can expand their tax base will continue to compete with other states to attract relocating tech companies. To the extent companies are planning to increase capital spending as a result of repatriation, full capital asset expensing or otherwise, careful consideration should be given to available state incentive programs that may augment any federal benefits.
After years of discussion and uncertainty, an end game is finally starting to materialize. Now is likely the time to analyze, plan, and take action, and no one in the organization should be standing on the sidelines. The changes to the tax code made by Congress in 2017 are going to affect tech companies at their core, so every executive should consider how it will impact their domain and how they can respond.

Questions business leaders should think about

**CEO**
What new growth or transformational operational opportunities does the tax act offer?

**CFO**
What is the impact on my current and prospective financial statements? What is the impact on in-flight or proposed company investments?

**Treasury**
How do I deploy cash most efficiently and effectively globally?

**LOB/Business Heads**
Should I consider restructuring my operations in light of the tax act?

**IT**
Are there information needs and system changes that will be required to reflect tax and business changes that are coming?
Let’s talk

There is little doubt that digesting the bill originally known as the Tax Cuts and Jobs Act will take some time. The provisions are complex, and the implications for technology companies are likely far-reaching. But Deloitte’s Tax professionals are a step ahead. We’ve already dug in and examined the Act in minute detail. We understand the changes and can help guide clients through the twists and turns. Let’s talk about what tax reform can mean to you.

Contacts

Janet Moran
Principal, Deloitte Tax LLP
jmoran@deloitte.com

Brian Pinto
Partner, Deloitte Tax LLP
bpinto@deloitte.com

www.deloitte.com/us/flashpoints

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