

At the intersection of international
tax and digital transformation

US tax reform impact on the technology sector



In Memoriam Allan Thompson

This column is dedicated to the memory of Allan Thompson, who was a valued colleague at EY and lead author for this article as well as our recent contributions to *Global Tax Weekly*.

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EY is a regular contributor to CCH's *Global Tax Weekly*. As tax and technology professionals, from member firms around the world, we share our insight and technology perspective on topics of interest to executives faced with taxation issues resulting from disruptive innovation and technology enabled digital transformation. This column is reprinted with the publisher's, *Wolters Kluwer*, permission from *Global Tax Weekly*, and originally appeared on pages 5-24, Issue 232 on 20 April 2017.

I. Overview of US tax reform proposals

Tax reform is a clear priority for Congress and President Donald Trump, and Republican control of both houses of Congress and the White House makes the prospect of achieving significant tax reform more likely within the year.

House Speaker Paul Ryan and Senate Majority Leader Mitch McConnell have each pledged to move tax reform legislation using “budget reconciliation” procedures. The use of the reconciliation process would mean that only 50 votes would be necessary to approve legislation (with Vice President Mike Pence serving as the tie-breaking vote) rather than the usual 60-vote supermajority needed to move most legislation through the Senate. This scenario in the Senate, plus the wide Republican majority in the House, suggests that a tax reform measure could pass with only Republican support.

A. House Republican Blueprint

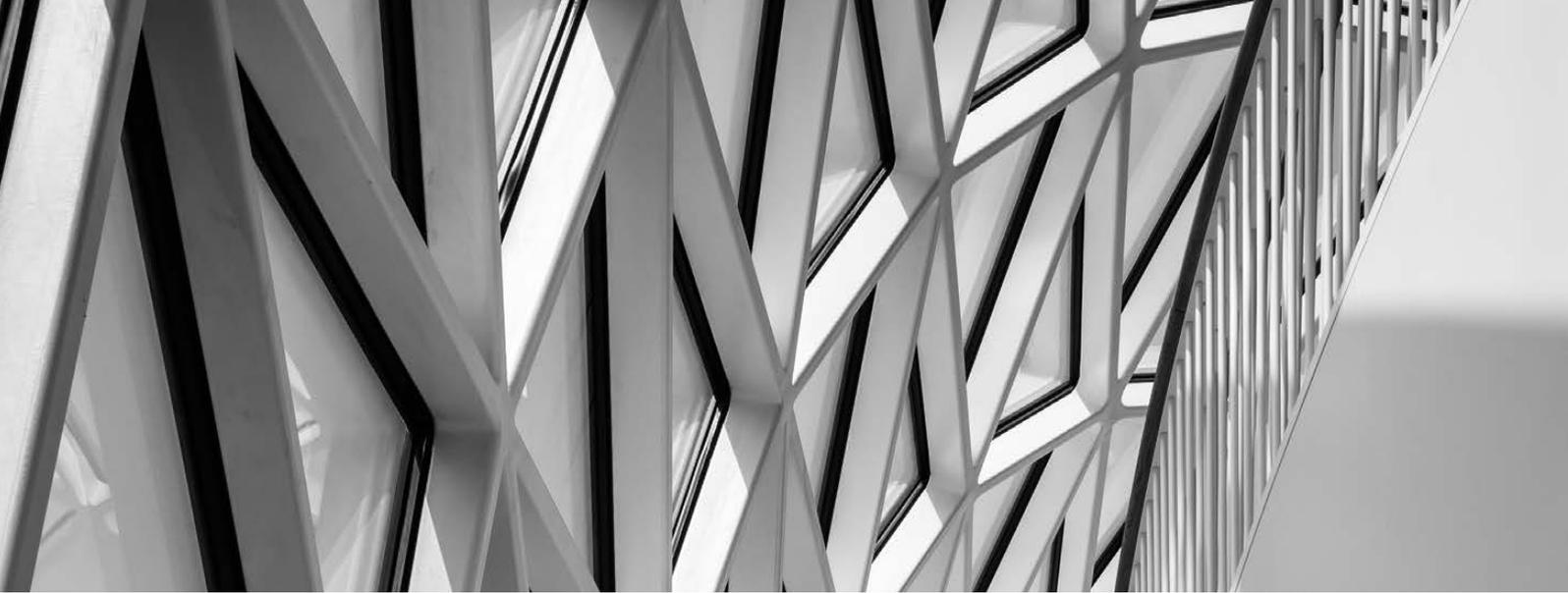
1. Key Blueprint provisions

It is likely that the House Republican Tax Reform Blueprint will be one starting point for tax reform legislative language. Broadly speaking, the Blueprint calls for reducing the top corporate tax rate from 35% to 20%. However, the changes proposed by the Blueprint go beyond tax rates. Of particular import, the Blueprint calls for a potentially significant tax benefit in the form of full and immediate expensing of investments in all tangible, intangible and real property (other than land).

At the same time, however, the Blueprint proposes to eliminate deductibility of net interest expense, which would constitute a repeal of a very significant business tax benefit.

On the international front, the Blueprint would move to a territorial tax system, meaning a 100% exemption for dividends paid from the future active earnings of foreign subsidiaries. An 8.75% tax rate would be imposed on previously untaxed accumulated foreign cash or cash-equivalent earnings, and a 3.5% tax rate would apply to all other accumulated foreign earnings, payable over eight years.

Existing provisions	Blueprint proposals
Top corporate tax rate (now 35%)	20%, corporate alternative minimum tax (AMT) eliminated
Top pass-through rate (now 39.6%)	25%
Taxation of future foreign earnings	Territorial; 100% exemption for dividends paid from foreign subsidiaries; border adjustment
Mandatory tax, untaxed accumulated foreign earnings	8.75% for cash/cash equivalents, 3.5% otherwise, payable over eight years
Cost recovery	100% expensing; tangible, intangible assets
Interest	No current deduction would be allowed for net interest expense
Other business preferences	Calls for them to generally be eliminated, except for research and development (R&D) credit and last-in, first-out (LIFO) accounting



2. Border-adjusted tax

In a stated effort to improve US competitiveness and the US balance of trade, the Blueprint also includes a proposal that would replace the corporate income tax with a destination-based tax on domestic consumption that would result in a 20% “border-adjusted” cash flow tax. Border-adjusted taxes are most commonly used within a value-added tax (VAT) system to ensure that (i) domestic rather than foreign consumption is taxed and (ii) the system is fair and does not result in double or non-taxation. For example, under a destination-based VAT, imports are subject to tax, while exports are exempt. Exporters are not subject to VAT on goods destined for foreign markets, because it is assumed that the country of destination will levy VAT upon import. Levying VAT on both the export and the import would result in double tax; hence, exports are border-adjusted to achieve neutrality in cross-border trade.

While the border-adjustment principles in the Blueprint are similar to those in a VAT, the tax base is different. The tax base for VAT is value added, the difference between the revenues received on sale and the cost of inputs. The Blueprint also allows businesses to deduct domestic expenditures for wages and salaries, capital investment, and other business expenses. Because of this difference, the House plan is sometimes referred to as a cash flow tax.

B. Trump plan

During his 2016 presidential campaign, Trump offered a framework describing what tax reform might look like if he were to become president. From a high-level policy perspective, the Trump plan is consistent with the Blueprint insofar as the most significant aspect of the Trump plan is a reduction in tax rates coupled with the elimination of special-interest deductions and credits. The Trump plan differs from the Blueprint in that it calls for a 15% tax rate with respect to corporations and on income from pass-through entities.

In relation to immediate expensing for investment in business assets and interest deductibility, the Trump position appears to limit such expensing to manufacturers, compared to the Blueprint’s proposal to make it more broadly available – and for those manufacturers that make this election, the deduction for corporate interest expense would be lost.

Regarding international taxation, the Trump plan is similarly vague. Trump and his staff have expressed support for a 10% tax rate on the deemed repatriation of previously untaxed foreign earnings of US companies, but it is unclear whether they also support repeal of deferral in a new international tax system going forward.

C. Camp plan

Prior to the Blueprint proposal, in February 2014, former House Ways and Means Committee Chairman Dave Camp (R-MI) released as a discussion draft a comprehensive proposal for tax reform. Given the similarity of their policy objectives, many believe the Camp plan to be a precursor of the Blueprint and a ready source of potential tax reform legislative language.

On the international front, the Camp plan proposed a number of substantive changes to the international tax regime. Specifically, the Camp plan proposed that all US shareholders that owned a 10% interest in a foreign corporation be subject to a one-time transitional tax on their pro rata share of the foreign corporation's post-1986 tax-deferred earnings (mandatory repatriation). This tax could have been paid over an eight-year period and would have been determined using an 8.75% tax rate in the case of accumulated earnings held in cash, cash equivalents or certain other short-term assets, or 3.5% in the case of accumulated earnings invested in

property, plant and equipment. An affected US shareholder with a 10%-or-greater stake in a foreign corporation with a post-1986 accumulated deficit would have been able to offset the deficit ratably against tax-deferred earnings of other foreign corporations. Policymakers might look to the Camp plan for guidance in drafting any new mandatory repatriation legislation.

D. Impact of tax reform on the technology industry

The technology industry encompasses an array of subsectors on a global scale, including semiconductors, computer hardware and peripherals, software and internet/new media. Because of the significant variances of operational models across subsectors, the effects of US tax reform would vary substantially based on an enterprise's global supply chain.

For instance, from a domestic tax perspective, proposals to lower the corporate tax rate to 20% with immediate expensing of investments would generally be beneficial across the board. But the elimination of the domestic manufacturing

deduction and other similar regimes could blunt some of that benefit. From an international tax perspective, the transition to a territorial tax system where future foreign earnings can be repatriated without additional US tax would competitively align US-based technology companies with the rest of the developed world. However, the mandatory transition tax on un-repatriated accumulated foreign earnings could have a substantial negative impact, as many technology companies hold significant cash/cash equivalents in foreign affiliates. Finally, the impact under the border-adjusted tax proposal could be positive if the company is a net exporter or negative if the company is a net importer. Hence, the effects of tax reform on specific technology companies would depend on their worldwide supply chain structure and the location of their customers.

In weighing the mix of tax reform proposals under consideration, technology companies should model the proposed domestic and international tax changes, as the impact could vary greatly depending on how the business is structured.

II. Domestic tax considerations

The tax reform provisions that are most impactful to technology companies from a domestic tax perspective are the research credit, domestic manufacturing deduction (Section 199), expensing provisions, border-adjusted tax and state tax implications. It is likely the proposed tax changes will cause technology companies to evaluate their overall supply chains, including where products are produced and by whom.

A. Federal tax considerations

The Blueprint and the Trump plan have identified the research tax credit as an important incentive and economic driver, and both plans propose to keep the research tax credit relatively unchanged. Prior research credit proposals have included the elimination of the regular computation and its associated base complexity for an alternative simplified credit coupled with an increase in the credit increment percentage, but it's uncertain whether the final reform package would incorporate these changes. Conversely, the Blueprint and the Trump plan have identified the Section 199 domestic manufacturing deduction as a potential target for elimination. Both plans propose to remove Section 199 in exchange for lowering the overall corporate tax rate, thus simplifying the tax code and effectively transforming the deduction into a more broadly applicable tax rate reduction for all corporate taxpayers.

The Blueprint envisions very broad immediate expensing of tangible and intangible property, while the Trump plan only includes the immediate expensing of property, plant and equipment for US-based manufacturers. The extent and type of activity that would constitute US-based manufacturing under the Trump plan have not yet been specified. Ironically, it's possible that the rules to satisfy the

"domestic production" requirements for expensing may be the same as Section 199 by demonstrating that the taxpayer's US-based activities were "substantial in nature" in relation to their manufactured products, or that the US-based direct labor and overhead were at least 20% of the value of the products, in terms of the cost of goods sold (COGS). It is uncertain whether software development would be considered manufacturing for the expensing provisions. It appears that many provisions related to inventory that impact technology companies would remain unchanged, including the Section 263A uniform capitalization regime.

For those technology companies that are currently in losses from operations or large stock option exercises, the value of the net operating losses would decrease with a decrease in tax rates. The research credit would remain an offset against the taxes paid vs. income generated, and therefore research credit carryforwards would retain their value. It would likely make sense for companies claiming the credit and in losses to add back the research credit vs. claim the Section 280(C) reduction, in order to consume the net operating losses and preserve the full credit. It likely also makes sense for companies to explore the impact of accounting method changes considering the reduction in rates, their tax attributes, prospects for taxability and potential changes to ownership or in capital structure.



1. Federal tax impact on the technology sector

Given the significant differences in business models across the technology industry, the following summarizes the potential federal tax impact of the Blueprint and the Trump plan by technology subsector.

a. Computer hardware and peripherals

Companies that develop software and hardware in the US would continue to receive the benefit of the research credit under both plans. To the extent that these companies develop prototype designs of tangible property through third-party overseas contractors, these amounts may be either nondeductible services or supplies. If supplies, these amounts may no longer be eligible for the credit if no longer deductible under Section 174. Conversely, if amounts are credit-eligible even though nondeductible, a company may no longer need to add back these expenses to income because there was no corresponding deduction.

Many of the companies in this sector do not manufacture in the US and therefore may not be receiving the Section 199 benefit for their manufacturing activities, unless they are claiming it on embedded software developed in the US that is within the tangible product. Nonetheless, the reduction in tax rates would more than compensate for the Section 199 benefit loss.

b. Semiconductors

The two types of semiconductor companies (fab and fabless) would continue to be able to claim the research credit for US-based development activities under both reform proposals. The fabless companies and companies that do not have US-based fabs are not likely to be impacted by the elimination of the Section 199 benefit, unless they claim that the development of semiconductors was a software development activity or they had the benefits and burdens of ownership during the manufacturing process that occurred in the US. Fabless companies would be negatively impacted by the border tax for imported product into the US to the extent that products are shipped to US-based customers; if they contract with a non-US fab company, they are not likely exporting product from the US and thus may not benefit from the tax exemption on exported goods. Companies that have US-based fabs greatly benefit from the expensing provisions, as the industry has significant capital investment in equipment and tooling. The companies with fabs would also benefit from the tax exemption on exported sales.

c. Internet and new media

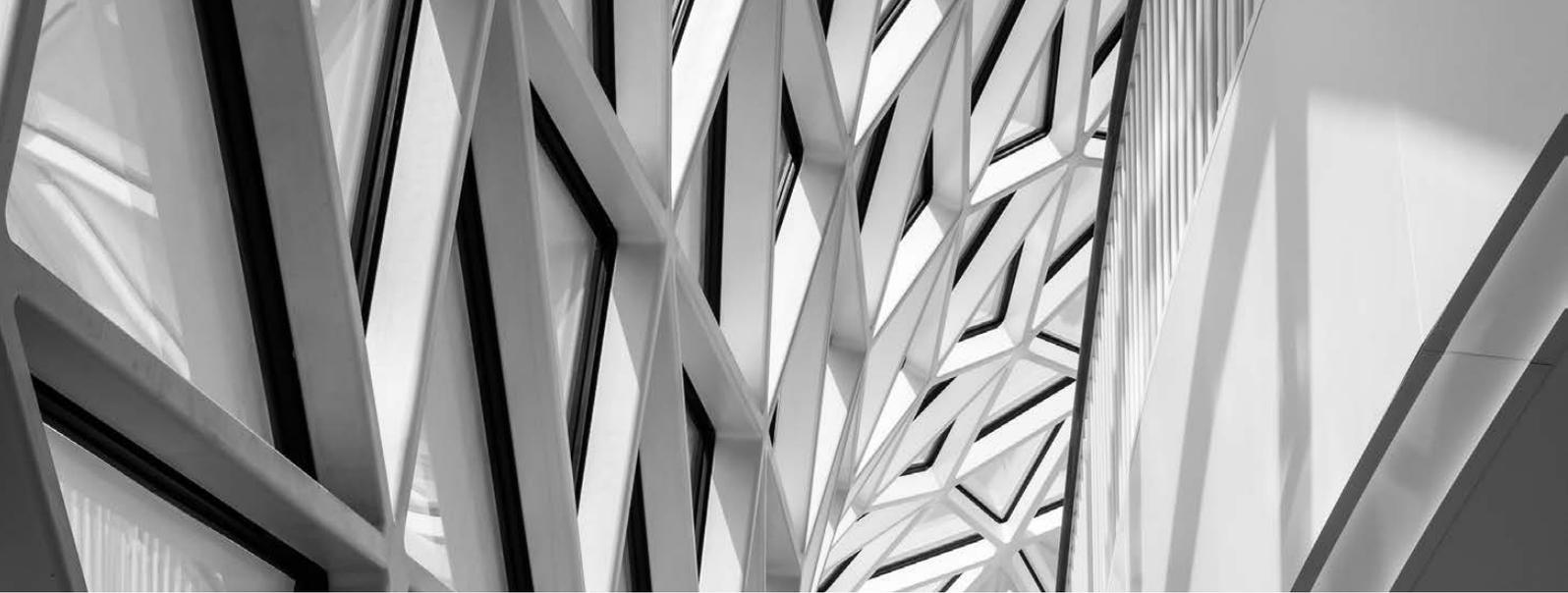
Most of these companies would continue to benefit from the research credit taken on their US-based software development activities. Many of these companies have faced challenges in claiming the Section

199 benefit on their software development activities because of issues related to identifying downloaded software comparables, advertising revenue and having the revenue characterized as services. As a result, the elimination of the Section 199 benefit may not impact this subsector as much as others.

If these companies are considered eligible for expensing provisions, this would be particularly impactful for those that own capital-intensive data centers. Under the Congressional plan for expensing intangibles, the costs of acquiring new digital content may be eligible for immediate deduction. Many of these companies purchase smaller start-ups for certain niche technologies. If structured as an asset sale, the intangible property (IP) portion of these companies may be eligible for immediate expensing under the Congressional plan.

d. Software companies

Software companies would continue to benefit from the research credit; however, most would be negatively impacted by the elimination of the Section 199 benefit. The expensing provisions would benefit those companies with larger amounts of office space to the extent applicable.



B. State and local tax considerations

While it is not expected that any federal tax reform would have significant implications for state taxes, such changes would almost certainly make state taxes a bigger priority for technology companies. As with the rest of the country, state policymakers are eagerly waiting to see what federal changes may be forthcoming in order to determine how and whether they must respond. Passage may very well occur after state legislatures have adjourned, resulting in at least a period of conflicting state and federal tax laws. Whether state legislatures would convene emergency sessions to address any inconsistencies is almost impossible to predict.

1. Federal conformity

States generally use the Internal Revenue Code as the starting point for determining state-taxable income and, if it changes, the state tax base should change as well. However, each state is different in how it conforms to Internal Revenue Code changes. Some states are so-called “fixed” conformity states, meaning that conformity to changes in the Internal Revenue Code is not automatic and requires legislative action to conform. Most other states are so-called “rolling” conformity states, meaning that conformity to changes in the Internal Revenue Code is automatic unless the state legislature expressly chooses to decouple from the federal changes. There are also a few so-called “selective” conformity states, meaning that conformity to changes in the Internal Revenue Code depends on which provision

of the Internal Revenue Code is changed and, in some cases, whether the state legislature has to update its conformity of that provision to that change.

While it is still too early to tell, it seems likely that doing nothing would result in increased state revenue for states that conform to the changes in the Internal Revenue Code simply because while these states conform to base changes, they generally do not conform to rate changes. Thus, because all of the current proposals suggest expanding the federal tax base in order to effectively reduce tax rates, the base expansion should flow through to the states but not the rate reductions, resulting in increased state tax revenues.

2. State and local tax impact on the technology sector

The following is a discussion of how the Blueprint and the Trump plan may impact the technology sector from a state tax perspective.

a. Taxation of foreign earnings

Depending on the plan and on the type of earnings (future or accumulated), repatriated foreign earnings would likely be treated as a dividend. For state tax purposes, dividends are generally allowed a 100% deduction. However, some states tax a portion of the dividend. In Massachusetts, for example, 5% of the apportioned share of a foreign dividend that is received from a non-unitary corporation would be subject to tax. In California, a corporation may eliminate 100% of dividends received from

a unitary subsidiary included within the same worldwide combined report. If it has a water’s-edge election, 75% of dividends received from a foreign subsidiary that is a member of the unitary group can be excluded, while 25% of the apportioned share remains subject to California tax. Worse, if the dividend is supported by non-unitary earnings and profits (for example, the dividend is paid by an acquired foreign corporation that had substantial non-unitary earnings and profits), no dividend-received deduction is currently available in California.

b. Cost recovery

Technology companies in capital-intensive subsectors that move operations to the US should benefit from the proposed change to the cost recovery rules. However, this benefit may not exist at the state level, as many states have decoupled from federal expensing and favorable depreciation due to revenue losses. If so, the federal benefits may result in an increased state tax compliance burden because, for example, companies would have to compute state-only depreciation.

c. Interest expense

Technology companies that usually borrow funds for such things as investment and stock buyback programs may be negatively impacted by the proposed change to the interest expense rules. However, the negative impact may not exist at the state level, as many states have decoupled from federal expensing and favorable depreciation due to revenue losses.

d. Other state tax considerations

Under both plans, it is expected that many credits would be eliminated but that the research tax credit would remain, which is a benefit for technology companies. This should not have much impact at the state level, as states usually impose state tax credits separately from those provided under the Internal Revenue Code. However, the recent calls for federal tax reform have emboldened officials in at least one state to revisit certain tax credits. A state tax official from California recently announced that his priorities for the 2017 legislative session include scrutinizing tax expenditures and that expenditures related to research tax credits are likely candidates for increased scrutiny.

The federal tax reform is not expected to have any direct impact on sales or property tax, but that does not mean that there would be no indirect impact. Reductions in federal tax would mean that sales tax and property tax would likely result in a higher percentage of the overall tax burden. Additionally, to the extent that a state's income tax revenue is impacted by the reform, it is likely that there would be efforts to fill that shortfall through other tax means. This could take the form of rate increases, expansion of the tax base, parcel taxes, transfer taxes or even new taxes depending upon the revenue impact.

To counteract those effects, some states would take steps to attract the investment that could come from the repatriation of earnings. States may expand their credits and incentives programs in an effort to attract technology investment, and the critical jobs they provide, to their jurisdictions. Technology companies with manufacturing operations or contract manufacturing arrangements outside the US may then move those operations back to the US, or at least require their contract manufacturers to do so.

Some technology companies have already begun discussions in anticipation of legislation, and this trend will likely swell as details of the reform emerge. Discussions prior to investment generally will maximize a company's ability to obtain more favorable credits and incentives and lower their above-the-line tax burden.

III. International tax considerations

US technology companies have long argued that because the US has the highest combined corporate tax rate in the industrialized world and an overly complicated and outdated tax system, US companies are at a significant tax disadvantage to their foreign competitors.

Because most developed nations have adopted territorial tax systems that exempt most foreign earnings from tax on remittance, US companies are less competitive against foreign companies that are not subject to taxation on active source foreign earnings and have lower corporate tax rates on earnings in their country. Additionally, many countries have “patent box” regimes that provide tax incentives for companies that relocate IP rights and personnel functions to their jurisdiction. As a result, US tech companies have had an incentive to shift investment and employment overseas and a disincentive to repatriate foreign earnings back to the US.

A. Border adjustment tax proposal

As mentioned above, the Blueprint also outlines a border-adjusted destination-basis tax system in which US revenue from sales to nonresidents is exempt from tax and the cost of domestic purchases is deductible, while the cost of purchases from nonresidents is nondeductible.

For example, if a US technology company purchases outsourced contract R&D services from either a related or unrelated foreign party, the costs associated with such services are not deductible against the US corporate income tax base. In this example, the loss of the deduction is the border adjustment under the Blueprint.

If, on the other hand, a US technology company sells product to a related or unrelated foreign person, the revenue attributable to that sale is not subject to US tax. In this example, the exemption of foreign revenue from the US tax base is the border adjustment. The result of the GOP’s plan is a cash flow tax on domestic transactions (e.g., a tax on US sales to US customers), where cross-border international trade is ignored under the plan.

Note that the border adjustment tax applies to the following types of income:

- ▶ **Tangible goods:**
 - ▶ Sales revenues for products sold by a US company to a non-US destination are tax-exempt.
 - ▶ Non-US expenses (e.g., payments to a non-US manufacturer) are not deductible.
 - ▶ Purchases of imported products are not deductible.
- ▶ **Services:**
 - ▶ Receipt of service income from a non-US party is treated as an export and is tax-exempt.
 - ▶ US expenses associated with services performed are deductible.
 - ▶ Payment for services performed outside the US is treated as an import and is not deductible.
- ▶ **IP flows:**
 - ▶ Receipt of royalties from outside the US for US-owned IP is treated as an export and is tax-exempt. US expenses associated with the IP are deductible. Non-US expenses (e.g., payment to a non-US R&D center) are not deductible.
 - ▶ Payment of royalties from a US-based company to a foreign owner of IP is treated as an import and is not deductible.
 - ▶ US companies that are parties to a cost-sharing arrangement would be able to deduct R&D activities performed in the US, but would receive no deduction for activities occurring outside the US.



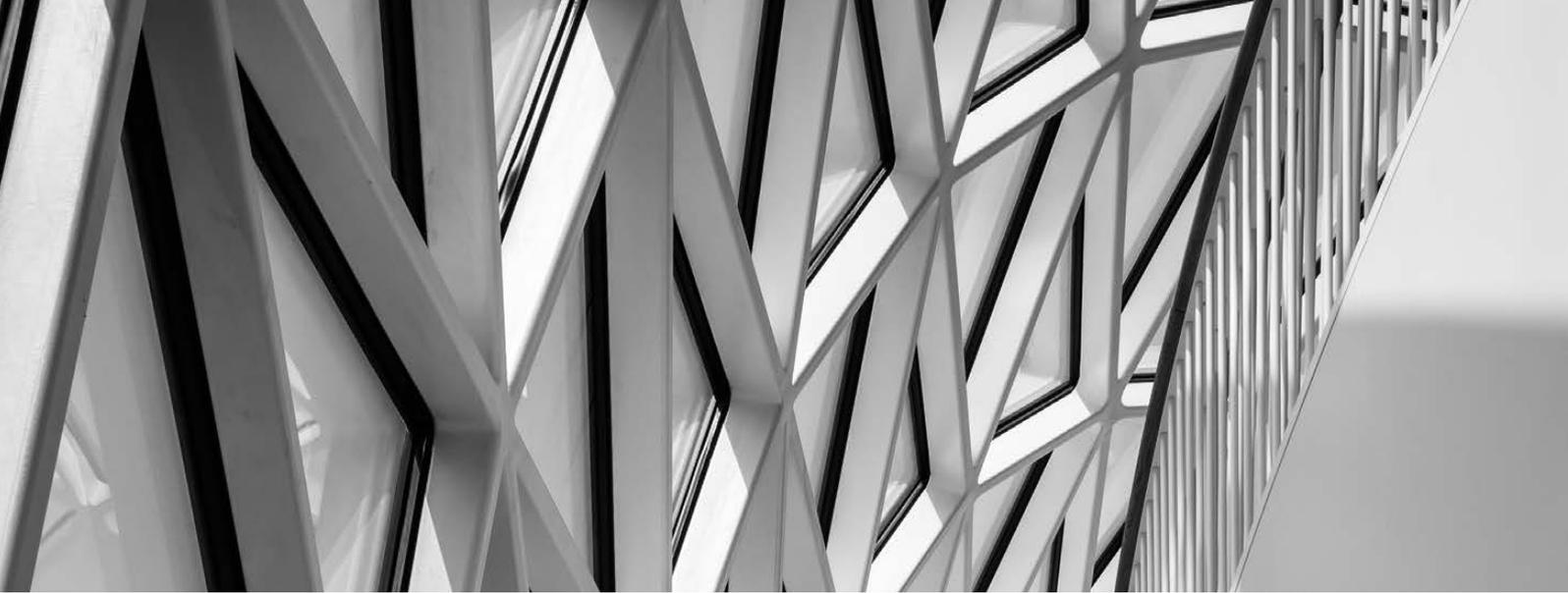
1. Trade impact

How does this Blueprint proposal potentially impact trade? First, the border adjustment provision is designed to encourage exports, which can have a significant impact on location of production and volume of trade. Second, the cash flow tax concept in the Blueprint is relatively novel, and it is not entirely clear whether border adjustments would be allowed under the World Trade Organization (WTO) agreements. Section XVI of the General Agreement on Tariffs and Trade (GATT) of 1994 and the Subsidies and Countervailing Measures (SCM) Agreement impose restrictions on export subsidies. Under the SCM Agreement, the full or partial exemption, remission or deferral specifically related to exports of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises is considered an impermissible export subsidy; however, an exemption of an exported product from taxes borne by the like product when destined for domestic consumption is allowed. The cash flow tax concept has elements of both traditional indirect and direct tax systems. The Tax Blueprint states that the border adjustment mechanism is consistent with WTO rules. This mechanism may be challenged by a WTO member, and with any challenge comes risk of retaliatory trade measures if the challenge prevails.

Additionally, the border adjustment aspect of a cash flow tax is designed to address some of the same trade-related issues that were discussed during the campaign. For example, one of the Trump campaign's criticisms of the North American Free Trade Agreement (NAFTA) was the perceived inequity of US-made products being imported into Mexico and subject to Mexican VAT, while products made in Mexico could be imported into the US untaxed. A border adjustment cash flow tax would also incent US manufacturing to remain in the US, as it would impose a border tax on products made outside the country.

2. Supply chain considerations

The adoption of border adjustments in the US business tax regime could cause wider changes to a company's supply chain. If the Blueprint is implemented, companies in the technology sector will likely need to think about the countries in which they are making capital investments, holding intellectual property, and producing for export. The trade agenda pursued by the Trump Administration may also impact these decisions, as well as sourcing decisions for goods and services. With the policy objectives of tax reform aligning with the Administration's trade agenda, businesses will want to be sure to consider the impacts of both tax and trade proposals, and jointly model specific impacts.



3. Transfer pricing considerations and case studies

As discussed above, technology companies frequently enter into cross-border intercompany transactions to facilitate expansion and grow business in foreign markets. Under current tax rules in the US and in most foreign countries, cross-border intercompany transactions are required to be priced according to the arm's-length principle (i.e., the intercompany transactions are priced as if they were transactions between two unrelated parties). The arm's-length principle has become the international standard for monitoring whether multinationals are artificially shifting income from high to low tax jurisdictions through intercompany trade.

In essence, however, the Blueprint border adjustment tax would eliminate the need to price cross-border intercompany trade according to the arm's-length principle, at least for US purposes. Indeed, the proposal eliminates the necessity for the US to monitor compliance with the arm's-length standard because under the Blueprint, cross-border international trade is ignored and multinationals no longer have the widely alleged incentive to shift income outside of the US to a lower tax jurisdiction. While the proposed border adjustment tax is intended to spur investment and economic growth in the US, it would have profound implications on the supply chains of US technology companies, which have frequently adopted various types of intercompany trade to facilitate expansion and grow foreign markets. And depending

on one's views of how quickly exchange rates would adjust in response to a border-adjusted tax,¹ the Blueprint could impact companies differently depending on the size and structure of one's supply chain and where one's customers are located.

a. Case Study 1: Early-stage software company with workforce and IP in the US

In this example, consider an early-stage software company (USCo) that has all of its workforce and IP in the US. Assume that USCo develops and sells software worldwide, with 75% of its revenue from sales to US customers and 25% from sales to non-US customers. All of USCo's inputs are sourced from within the US. Figure 1 below depicts these facts.

Figure 1: Early-stage software company



¹ See, e.g., Kyle Pomerleau, "Exchange Rates and the Border Adjustment," The Tax Foundation, 15 December 2016; and Gordon Gray, "Border Adjustments and Importing Firms," American Action Forum, 25 January 2017. According to advocates of the Blueprint, the supply and demand of the US dollar has a leveling effect within the context of border adjustments. The standard economic argument is as follows: (1) "Border adjusting" imports raises the cost and reduces the demand for foreign goods shipped to the US. When demand falls for foreign imports, the supply of US dollars to foreign markets also falls, making US dollars more valuable relative to other currencies. (2) Likewise, "border adjusting" exports reduces the cost and increases the demand for US goods shipped to foreign markets. When demand increases for US exports, the demand for US dollars also surges, making US dollars more valuable relative to other currencies.

Given this fact pattern and assuming no currency effects, the difference in tax treatment is significant under current US tax rules vs. the Blueprint. For example, under current rules, the US government taxes USCo on 100% of its sales (US and foreign) and allows a deduction on its expenses. However, under the House plan, non-US sales are border-adjusted and thus exempt from US taxation. Figure 2 summarizes the difference in US tax treatment, assuming \$100 of sales with no imports, \$25 of domestic wages and salaries, \$20 of capital purchases, \$10 of depreciation and \$5 of interest expense.

Under current rules, USCo has \$100 of taxable revenue and \$40 of deductions – wages and salaries, depreciation and interest expense. This results in \$60 of taxable income and \$21 of tax at a 35% rate.

Under the Blueprint, USCo is taxed on 75% of its revenue. The 25% of non-US sales is border-adjusted and thus exempt from US tax. Deductions under the House plan total \$45, which equals wages and salaries and capital purchases. This results in \$30 of taxable income and \$6 of tax at the proposed 20% rate. US tax decreases 71% under the Blueprint relative to current law.

Figure 2: Comparison of current tax law vs. Blueprint (case study 1)

Tax plan	Taxable revenue	Wages and salaries	Capital purchases	Depreciation	Interest expense	Taxable income	Tax (35% vs. 20%)
Current law	\$100	\$25	-	\$10	\$5	\$60	\$21
GOP plan	\$75	\$25	\$20	-	-	\$30	\$6

Figures do not include currency effects

The following are two important points to highlight from case study 1:

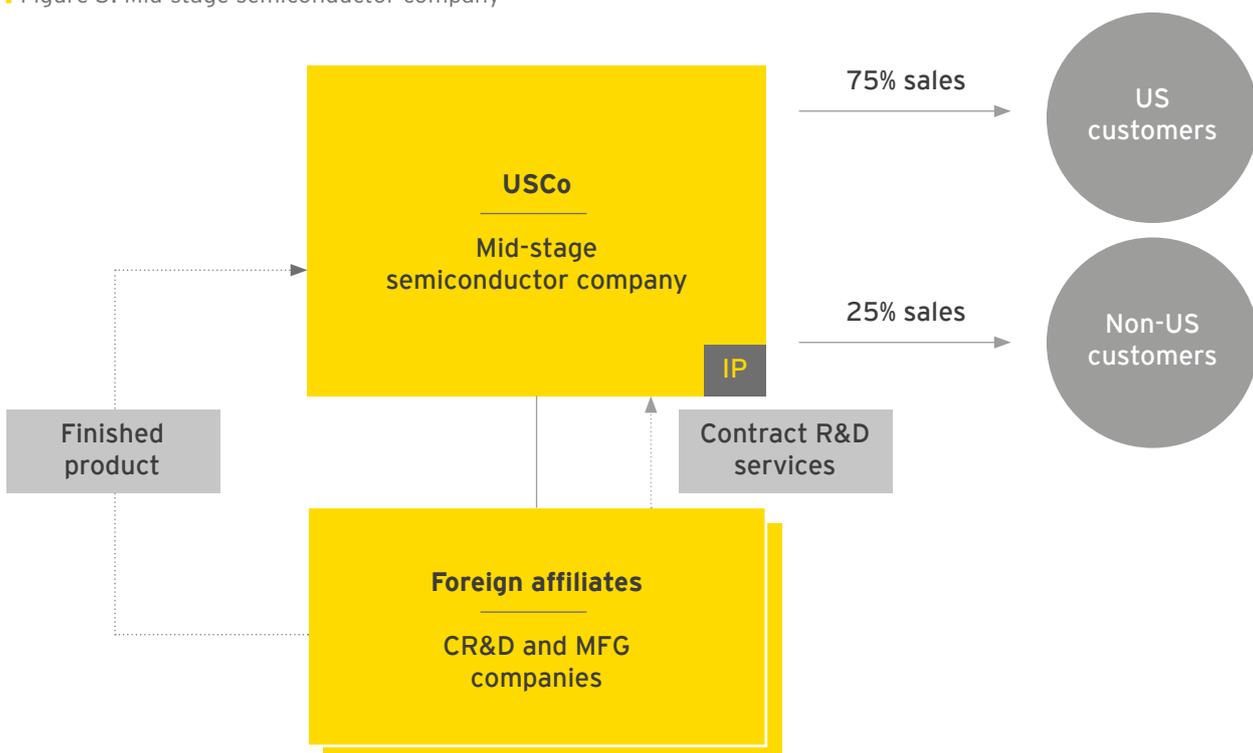
- ▶ There are no transfer pricing implications to case study 1 because USCo does not have an international supply chain or engage in cross-border trade for the sourcing of inputs.
- ▶ More generally, US companies that source inputs and labor from the US and that have a low percentage of non-US sales would be disadvantaged relative to US companies that have a higher percentage of non-US sales.

In fact, the latter group could find itself in a perpetual taxable loss position for US purposes, while the former group is subject to tax. This is because the House plan, as defined today, allows for a full deduction on US costs associated with non-US sales, which are border-adjusted and exempt from tax. Under the current example, USCo realizes a taxable loss once its sales to non-US customers reach 45% or higher. This result is in line with the GOP plan's design to reward companies for locating operations in the US and selling to foreign markets.

b. Case study 2: Mid-stage semiconductor company with US IP and foreign contract R&D and manufacturing

Now consider a mid-stage semiconductor company (USCo) that has its IP in the US but uses foreign affiliates to manufacture product (MFG Co) and to provide contract R&D services (CR&D Co). Assume that USCo develops and sells semiconductors worldwide, with 75% of its revenue from sales to US customers and 25% from sales to foreign customers. Figure 3 depicts these facts.

Figure 3: Mid-stage semiconductor company





Under USCo's global supply chain, it imports contract R&D services and finished product from foreign related parties. Assume the transfer price on the contract R&D services is \$15, while the transfer price on the finished product is \$50. Assume again \$100 of total USCo sales, 75% to US customers and 25% to non-US customers. Figure 4 summarizes the difference in US tax treatment under current tax law vs. the Blueprint, assuming further that USCo has \$10 of domestic wages and salaries, \$10 of capital purchases, \$5 of depreciation and \$5 of interest expense.

Under current rules, USCo has \$100 of taxable revenue and \$85 of deductions – imports from MFG Co, imports from CR&D Co, domestic wages and salaries, depreciation and interest expense. This results in \$15 of taxable income and \$5 of tax at a 35% rate.

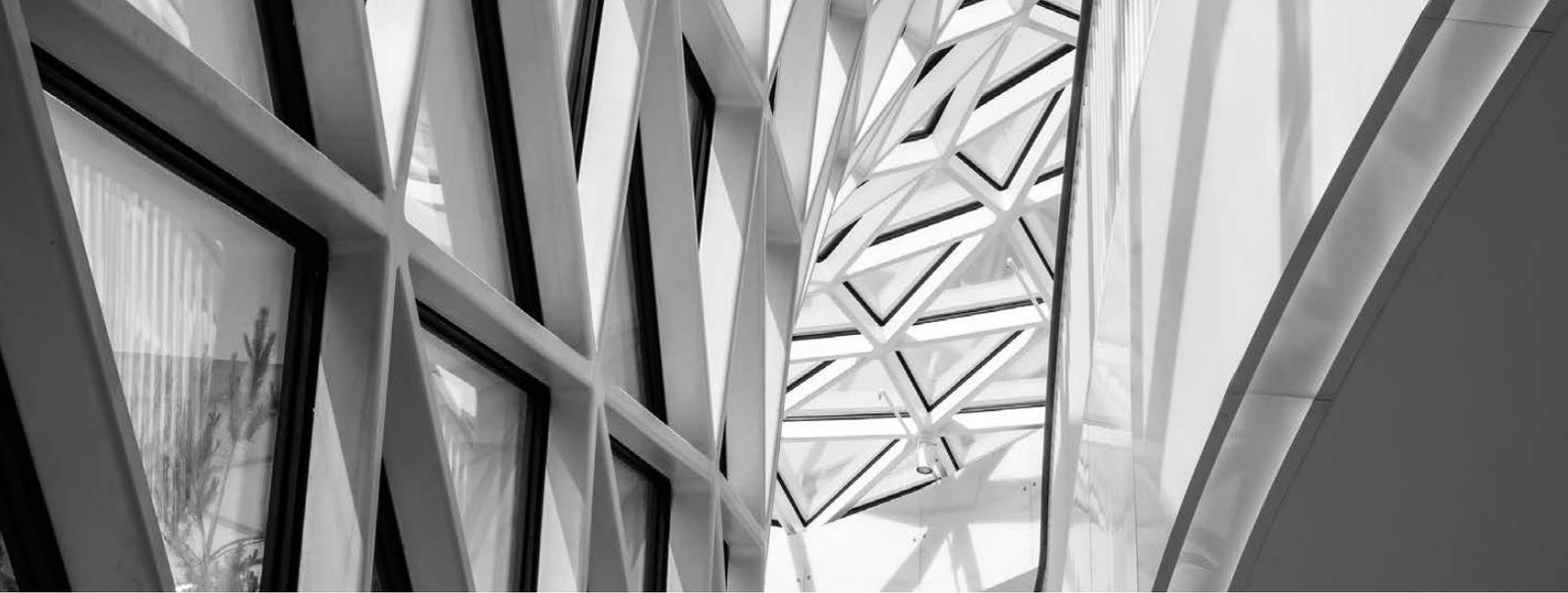
Under the Blueprint, USCo is taxed on 75% of its revenue. The 25% of non-US sales is border-adjusted and thus exempt from US tax. Deductions under the Blueprint total \$20 – domestic wages and salaries and

capital purchases. The imports from MFG Co and CR&D Co are border-adjusted and thus nondeductible. This results in \$55 of taxable income and \$11 of tax at the proposed 20% rate. US tax increases 110% under the Blueprint relative to current law.

Figure 4: Comparison of current tax law vs. Blueprint (case study 2)

Tax plan	Taxable revenue	Imports from MFG Co	Imports from CR&D Co	Wages and salaries	Capital purchases	Depreciation	Interest expense	Taxable income	Tax (35% vs. 20%)
Current law	\$100	\$50	\$15	\$10	-	\$5	\$5	\$15	\$5
GOP plan	\$75	\$0	\$0	\$10	\$10	-	-	\$55	\$11

Figures do not include currency effects and for simplicity ignores sub part F implications



The following are important points to highlight from case study 2:

- ▶ Under the Blueprint, USCo's transfer pricing policies on the import of contract R&D services (\$15) and the import of finished product (\$50) are no longer relevant for US tax purposes because the Blueprint ignores cross-border international trade. This is highlighted in Figure 4. In contrast, under current US law, the prices paid for finished product and for outsourced R&D services are subject to the arm's-length standard, as those amounts directly impact the amount of deductions USCo is allowed to take for tax purposes.
- ▶ Under the Blueprint, companies that have implemented international supply chains to import goods and services to the US are at a disadvantage relative to companies that instead source labor and other inputs from US markets. This is because the Blueprint "border adjusts" imports by eliminating the deduction, effectively penalizing companies with international supply chains that source goods or services to the US. This is true regardless of whether the company sells to US or foreign markets. In the latter case, while the revenue is exempt and not subject to tax, the costs associated with foreign sales are deductible if production is US-based and not deductible if production is foreign-based. Again, this reflects the Blueprint's design to reward companies for locating operations in the US and selling to foreign markets.

As the case studies demonstrate, the Blueprint eliminates the incentive for multinationals to shift income from the US to low tax jurisdictions; however, foreign jurisdictions still rely on the arm's-length standard for evaluating whether firms are artificially shifting profits. Foreign taxing authorities are likely to ramp up enforcement efforts and propose aggressive transfer pricing adjustments. Foreign transfer pricing enforcement efforts are already higher than they have ever been because of the Organisation for Economic Co-operation and Development's recent guidance around base erosion and profit shifting and media reports of US multinationals engaging in income shifting. This trend is expected to continue if the Blueprint is adopted, so technology companies should begin developing their transfer pricing audit defense strategy and support.

4. International tax impact on the technology sector

The border adjustment proposal could significantly affect the technology industry, particularly for subsectors that rely heavily on complicated global supply chains. Many technology companies have located substantial, valuable IP outside of the US. Often, such companies have cost-sharing arrangements in place whereby the development costs of the IP are shared by two (or more) principals – generally a US principal and a foreign principal. The working assumption under the border adjustment proposal is that the costs incurred for R&D activities performed in the

US would be deductible and those incurred for activities performed outside the US would be nondeductible. Presumably, the net payment in or out of the US would be the only amount that is impacted, but this is yet to be determined. Companies should look at their existing cost-sharing structures and consider the potential impacts based on the location of the services performed and net payment flows, particularly in a cost-sharing scenario.

Additionally, in many cases, technology companies have located worldwide IP outside the US. In certain situations, a US-based company may pay royalties to offshore entities for use of the US IP. The impact of these payments should be examined to understand the net impact of the border adjustments to the US tax posture. Depending on expectations as to regional growth, the location of substantive people functions on a global basis and the ease with which the business can change its supply chain, companies may consider whether moving some portion of their IP back to the US could be beneficial in the case of border adjustments and otherwise neutral (in the instance that border adjustments are not implemented).

a. Computer hardware and peripherals

A vast amount of companies in the computer and peripherals subsector manufacture overseas, in which case the border adjustment tax on imported products would significantly increase the costs for these companies – many of which are characterized by relatively low margins.

Even those that do manufacture in the US often have a significant amount of imported parts from reliance on raw material sourcing. Further, companies that contract manufacture goods overseas would not likely benefit from the elimination of taxes on exported items considering their likely supply chains.

b. Semiconductors

Few industries have business operations that are as complex and geographically widespread as semiconductor manufacturers. Players in the semiconductor space also vary dramatically in their supply chain structures, and these differences would undoubtedly affect the extent to which they are impacted by border adjustments. For example, the border adjustments could prove favorable for semiconductor companies that own manufacturing plants in the US, as they are most likely net exporters. However, for US-headquartered fabless semiconductor companies, the border adjustment proposal could be neutral or slightly detrimental. The fab or fabless nature of a given company's supply chain, coupled with the company's IP ownership structure, could also generate unpredictable results depending on the magnitude of manufacturing inside vs. outside the US, volume of imports to the US market and cross-border royalty and services payments.

c. Internet and new media

It is unlikely that US-based internet/new media companies would be as negatively impacted by the border tax adjustments because they tend to sell intangibles or services as a net exporter. However, if there are significant IP or service payments made

to non-US entities, these amounts may not be deductible in the US. This could have a considerable impact to those companies paying significant royalties overseas or under a cost-sharing arrangement.

d. Software companies

Similarly, the border adjustment tax is not likely to negatively impact software companies as compared with those that manufacture and sell tangible property. However, it would have a negative impact on software companies that pay for services and royalties to non-US entities.

B. Mandatory repatriation

By some estimates, US companies hold US\$2.5 trillion of cash overseas, with technology companies comprising 40% of that total. Because both developed and developing countries alike have increasingly used business and tax incentives to entice high-tech investment, the benefit for US technology companies to use foreign earnings for any number of offshore ventures has historically outweighed the cost of repatriating those earnings back to the US.

Mandatory repatriation provisions could subject a US shareholder to immediate, but reduced, US taxation on earnings of a foreign corporation not previously subject to US tax (deferred foreign earnings). This would apply to a foreign corporation that is either a controlled foreign corporation or a foreign company where one US corporation owns a 10% voting interest. A US shareholder required to include deferred foreign earnings into income would be entitled to a deduction, potentially resulting in an 8.75%

effective tax rate for earnings attributable to cash or cash equivalents, and any remaining earnings would be subject to 3.5% effective tax rate.

This deemed repatriation proposal could significantly affect technology companies that have earnings and cash/cash equivalent balances in foreign corporations owned by US companies that have not been repatriated. These companies should analyze the earnings and profits, tax pools and cash/cash equivalent balances of their foreign subsidiaries to determine what the effect on their US tax liability could be if this proposal is enacted. Companies should consider whether deductions can be accelerated or income deferred to future years to reduce the effect of the deemed repatriation charge.

C. Conclusion

While questions about the timing and structure remain, technology companies should start considering the issues raised by the US tax reform proposals and how they may be affected. Even if tax reform is revenue-neutral overall, the specific circumstances of each company may not reflect that. Technology companies should consider evaluating their supply chains for manufacturing and IP, sourcing options, locations of value-added activity, production for or licensing to export markets and capital expansion. Each factor can influence US tax liability significantly if the border-adjusted cash flow tax approach is adopted. Technology companies should also consider the current and future availability of deductions in their planning.

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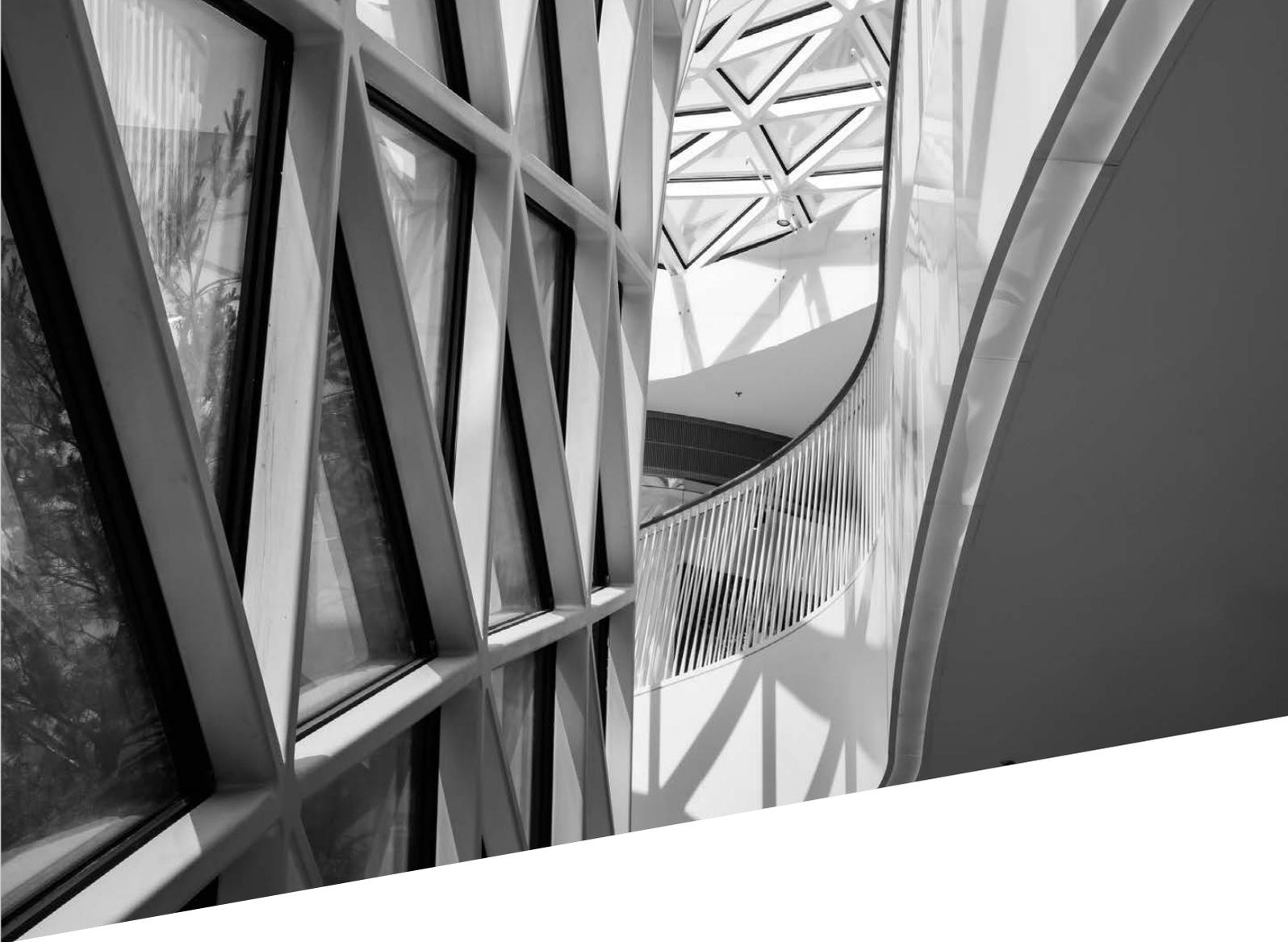
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The views expressed in this column are those of the authors and do not necessarily reflect the views of the global EY organization or its member firms. Check with your local EY tax advisor for the latest information regarding these rapidly developing topics.



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