TAX & TECH:

What Does Tax Reform Mean for American App Developers?

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April 15th is marked on calendars throughout the United States because every American, across our country's 435 congressional districts, is impacted by taxes. In the midst of our country's ongoing tax debate, individuals, businesses, and organizations are all watching to learn what tax reform means for them. But what does it mean for you?

This handy document is here to help.

The last time Congress passed an overhaul of the tax code was the Tax Reform Act of 1986. More than three decades later, tax reform is again a top priority for Congress and the White House, with several plans and objectives released this year. But how did we get here, and what do proposed tax reform plans mean for American app developers and innovators?

Regardless of political affiliation, taxes are an important bipartisan issue for all Members of Congress and the executive branch. However, the 2016 election secured Republican leadership in the House, Senate, and White House, providing the party with a rare opportunity to drive the conversation and the policy decisions about tax reform.

App developers and small business tech companies must prepare for what a new tax reform bill might look like. We must fully consider what reforms affect tech innovators, what elements must be kept, and what progress we want to see.

This booklet will explore key issues within the broader tax reform conversation, as well as several related issues that must be addressed to protect and provide more opportunity to small technology companies. We also provide information on the important players and plans, as well as key terms to know for tax reform.

KEY ISSUES

Internal Revenue Service (IRS) Auditing Practices:

The IRS audits businesses of all sizes, and the due process protections and subsequent appeals within these audits are especially important for smaller companies. While larger companies may be able to challenge the IRS on wrongful audits and can absorb the costs of inefficient or unfair processes, smaller companies face a heavier burden. Recently, the IRS has used worrisome tactics to win judgments against taxpayers. In July 2017, the House introduced the Preserving Taxpayers' Rights Act, H.R. 3220, to address these practices and end the following activities:

- Hiring a third-party litigation firm to audit a taxpayer, rather than having the IRS perform the audit.
- Unilaterally suspending the statute of limitations for conducting an audit by issuing a designated summons. This practice inappropriately shifts the burden from the IRS to the taxpayer, and it should only be used in extraordinary circumstances against uncooperative taxpayers. The IRS has also used intimidation tactics to pressure taxpayers to extend the statute of limitations, making a taxpayer's audit experience even more distressing.
- Unfairly forcing litigation in expensive courts. The IRS has not been providing taxpayers with the opportunity to resolve issues in the IRS Office of Appeals before being forced to litigate in the more expensive Tax Court. Requiring appeals to go directly to Tax Court disproportionately impacts smaller businesses, and in some cases, taxpayers have been required to extend the statute of limitations by twelve months just to be able to go to Appeals.

KEY ISSUES

Repatriation:

Repatriation refers to earnings and profits (E&P) that American companies earn in foreign markets and bring back to the American economy. Current U.S. regulations tax foreign-earned profits at higher percentages than profits earned domestically, prompting companies to keep their earnings overseas and outside of the American economic stream. These “trapped funds,” worth an estimated $2 trillion, could have great benefits for small businesses if they were accepted and invested in the American economy. However, they can do nothing for American businesses if they remain overseas.

Two key questions are at the center of the repatriation debate:

- ***Why are these funds held outside the country?*** When American companies earn profits in a foreign market, the company must pay that country’s corporate tax rate on those earnings and profits. To “repatriate” the profits back into the United States, American companies must pay an additional 35 percent tax rate on those already-taxed profits. The 35 percent corporate tax rate in the United States is among the highest in the world.

  This onerous tax burden discourages American companies from repatriating their foreign-earned profits into the U.S. economy. This environment has immediate and negative downstream effects for the American companies that earned the profits, the U.S. small businesses that may benefit from it, and the American economy at large.

- ***How does this affect a small business operating in the United States?*** Repatriation is as much an issue for small businesses as it is for big multinational corporations. More immediately accessible capital in our economy could be used for venture capital projects, acquisitions, and investment in the small business innovators who create apps, systems, platforms, and products across the country. When companies return foreign-earned money to the American economy, they can invest in improvements to the platforms and resources small business developers use to sell their apps and services, like the App Store and Google Play, and improve the app and software industry’s products for all consumers.

Pass-Through Rate:

The pass-through tax rate refers to the method by which owners of a business pay taxes on their business income through their personal income tax returns. According to the Tax Foundation, 39 percent of small businesses use the pass-through rate to pay their taxes. More than 90 percent of businesses in the United States are classified as "pass-through entities," also known as "S-Corporations" or "LLCs." Many large multinational corporations take advantage of the pass-through tax rate to evade the higher, more burdensome corporate tax rate.

For small businesses to feel any direct impact or benefit from a congressional tax reform plan, it must be comprehensive tax reform. Reform that only lowers the corporate tax rate will not help the many small businesses owners who are taxed as pass-through entities.

PLANS AND PLAYERS

The main venues for tax reform include the House, the Senate, and the administration. Each has a different plan, and a few key players leading the charge.

The GOP Plan: "The Big Six Tax Plan"

This outline was introduced on September 27, 2017.

Negotiated by top Republican lawmakers and administration officials, the Big Six plan is a hybrid of the objectives proposed by the House, Senate, and White House. A formal plan has not been introduced.

Stated Plans

- Cut corporate tax rate from 35 percent to 20 percent.
- Reduce tax rates for small businesses and pass-through entities from a maximum of 39.6 percent to 25 percent.
- Adopt a "territorial tax system," where the profits of U.S. multinational companies are only subject to the tax of the government where the money was earned.
- Eliminate the alternative minimum tax.
- Reduce the number of income tax brackets from seven to three.

Key Players: The Big Six

- Secretary Steven Mnuchin: Secretary of the U.S. Treasury Department.
- Gary Cohn: Director of the National Economic Council.
- Representative Paul Ryan: Speaker of the House.
- Representative Kevin Brady: Chairman of the House Ways and Means Committee.
- Senator Mitch McConnell: Senate Majority Leader.
- Senator Orrin Hatch: Chairman of the Senate Finance Committee.

House Plan: Tax Cuts and Jobs Act

This plan was introduced on November 2, 2017.

Proposed Reforms:

- Reduce income tax brackets from seven to four: 12 percent, 25 percent, 35 percent, and 39.6 percent.
- Lower the corporate tax rate to 20 percent from 35 percent.
- Reduce the pass-through business income rate to 25 percent.
- Simplify processes for repatriation to encourage investment of foreign earned profits into the United States.
- Preserve the research and development tax credit to support American entrepreneurs and innovators.
- Eliminate the alternative minimum tax for individuals and corporations.
- Propose a 10 percent global minimum tax on American companies' foreign earned income.
- Gradual repeal of the estate tax.
- No changes to the pre-tax treatment of 401(k) retirement plan.
- Increase the child tax credit from $1,000 to $1,600

Key Players

- Representative Paul Ryan: Speaker of the House.
- House Ways and Means Committee: The House's tax writing committee.
- Representative Kevin Brady: Chairman of House Ways and Means Committee.
- Representative Peter Roskam: Chairman of House Ways and Means Tax Policy Subcommittee.
- Representative Richard Neal: Ranking Member of House Ways and Means Committee and the most influential House Democrat in the tax reform debate.
- New Democrat Coalition: Congressional organization seeking moderate and pro-growth legislation. Within the tax debate, the New Democrats are proposing a Democratic-led alternative tax plan to work with Republicans in the majority.

Senate Plan: Tax Cuts and Jobs Act

This plan was introduced on November 9, 2017.

Proposed Reforms:

- Preserve seven individual income tax brackets:

  10 percent, 12 percent, 22.5 percent, 25 percent, 32.5 percent, 35 percent, and 38.5 percent.
- Lower the corporate tax rate from 35 percent to 20 percent, effective 2019.
- Establish a 17.4 percent deduction for individual owners of pass-through businesses.
- Eliminate individual state and local tax deductions, while preserving corporate state and local deductions.
- Eliminate the individual alternative minimum tax.
- Implement a 12.5 percent tax on foreign profits earned from intangible assets such as patents, copyrights, and other intellectual property.
- Preserve the estate tax, but double the exemption for wealthy estates to $11 million for individuals and $22 million for couples.
- Increase child tax credit from $1,000 to $1,650 and lift caps so more parents qualify.

Key Players

- Senate Finance Committee: The Senate's tax writing committee.
- Senator Orrin Hatch: Chairman of Senate Finance Committee.
- Senator Ron Wyden: Ranking Member of Senate Finance Committee.

It is important to note that the Republican-led Senate passed a budget to support the passage of the broader Republican tax plan. The budget is important because it laid the procedural groundwork necessary for the Senate to consider tax reform under the budget reconciliation process, which would allow a tax reform bill to pass with a simple majority, and without the threat of a filibuster.

Administration Plan:

“2017 Tax Reform for Economic Growth and American Jobs”

This outline was introduced on April 26, 2017.

Stated Goals

- Lower the corporate and pass-through rates to a flat 15 percent “business tax.”
- Reduce the number of tax brackets from seven to three.
- Repeal the estate tax, alternative minimum tax, and the 3.8 percent Obamacare tax.
- Establish a territorial tax system to discourage off-shoring. The administration has not elaborated whether this will take the form of a border adjustment tax, tariff, or another alternative.
- Address repatriation through a one-time tax on American companies’ foreign-earned profits.

Key Players

- President Donald Trump: President of the United States.
- Secretary Steve Mnuchin: Secretary of the U.S. Treasury Department.
- Gary Cohn: Director of the National Economic Council.

Alternative Minimum Tax (AMT): The AMT is often levied alongside the normal income tax. If taxpayers reach a discrepancy in their tax rate, the AMT requires them to calculate the taxes they owe twice and pay the higher amount. This tax was established to prevent tax avoidance by wealthy taxpayers, but according to the Tax Policy Center, this tax applies to nearly 5 million taxpayers.

Blueprint: The “Blueprint,” officially known as “A Better Way Forward on Tax Reform,” represents House Republicans’ outline for a tax reform bill. House Ways and Means Republicans released it in June 2016.

Brackets: A tax bracket refers to the tax rate that is paid by a range of incomes. Tax brackets create progressive income tax structures. For example, if a taxpayer makes $10,000-$15,000 a year, their income tax rate is X; but if a taxpayer makes $200,000-$300,000, their income tax rate is Y.

Capital Expensing: This term refers to the “immediate depreciation of capital expenditures,” or the act of allowing businesses to immediately deduct the full cost of a capital investment, like the purchase of faster machinery or a new manufacturing facility. This is also called “immediate expensing” or “expensing.” The current system requires taxpayers to depreciate the cost of the investment over many years, even though the investment loses value over the time the company pays for it.

Capital Investments: Capital investments represent funds invested for long-term uses. These funds may be for internal uses, like a new factory or more efficient technology, or external uses, like venture capital, angel investing, or services from financial institutions.

Consumption Tax: As its name suggests, a consumption tax is levied on the consumption of a good or service. Sales taxes or tariffs are examples of a consumption tax.

Estate Tax: A tax on the net value of an estate that must be paid after the owner's death and before heirs may receive inheritance, if the cash value of the inheritance exceeds a certain threshold. The IRS defines estate tax as "a tax on your right to transfer property at your death," except if the transfer is made to a surviving spouse. This is often referred to as the "death tax."

Flat Tax: This tax rate is applied uniformly amongst taxpayers, regardless of their income. Flat taxes include payroll taxes.

Innovation Box: Innovation box proposals would provide a tax credit that applies a lower tax rate on profits earned from intellectual property (IP). By taxing profits from IP at a lower, more attractive rate, an innovation box encourages companies to conduct more research, development, and production inside the United States.

Internet Sales Tax: This is a misnomer, as there is currently no internet sales tax. However, a debate continues about e-commerce and how online businesses may go about charging customers sales tax. The law, defined in a landmark Supreme Court case regarding magazine catalog sales, says businesses must charge customers sales tax in the state(s) in which the business has a physical presence, like a store or warehouse. While the rapid growth of e-commerce has revamped this argument, particularly in states that want to grow revenues through internet sales, current law does not require companies to pay sales taxes to the states in which purchases are made. Instead, companies pay sales taxes to the states in which their business is physically located.

Pass-Through Entities: S-corporations (corporations that pay corporate gains, losses, deductions, or credits to shareholders) and LLCs (corporations where company members cannot be liable for the company's gains or losses) are entities that pay business taxes through the owner of the business. A pass-through entity's taxes are filed through the individual tax system. Most small businesses are categorized as pass-throughs.

Pass-Through Rate: This tax rate is applied to pass-through entities that file taxes through the individual tax system, separate from the corporate tax system. Since most small businesses are classified as "pass-throughs" the pass-through and individual tax rates are crucial to small businesses. Unfortunately, the Blueprint tax plan does not address the pass-through rate.

Progressive Tax: A tax is progressive if household tax rates increase with household income. In other words, progressive taxes take a larger percentage from high-income earners than from low-income earners. The progressiveness of a tax depends on the proportions by which tax rate increases with income. Our current income tax structure is progressive.

Regressive Tax: Taxes are considered regressive when the same rate is applied uniformly, regardless of the income of the taxpayer. This disproportionately affects lower-income taxpayers, because low income taxpayers will spend a larger portion of their earnings than their higher-income counterparts. Regressive taxes can include sales taxes, user fees, and property taxes.

Repatriation: Repatriation is the process of bringing profits earned overseas into one's home country, i.e. when an American business brings profits earned in Germany back to the United States. Estimates show that roughly $2 trillion of American companies' profits are "trapped" outside of the United States due to high tax rates on repatriated profits.

Research & Development (R&D) Tax Credit: Companies may claim this tax credit if their business invests in R&D. The R&D tax credit is essential to innovators in all industries. This allows companies to save on taxes while allocating more funds to conduct research that will improve their business, their effectiveness, and their industry as a whole.

Revenue-Neutral: Within the context of tax reform, revenue-neutral requires changes made to the tax code that would result in less money coming into the U.S. Treasury be offset by measures that will allow the government to raise the same amount of revenue before any tax reforms become law. For example, if legislation lowers corporate or individual tax rates, it must also implement a policy to raise revenue to be considered revenue-neutral.

Subsidy: A benefit given by the government or a public group, usually in the form of a cash payment or tax deduction, to assist an industry or business keep the price of an essential commodity or service low and competitive. Subsidies are generally considered to be in the public's interest.

Tariffs: A tax or duty applied to certain goods or a class of imports/exports. Tariffs are often used to manage trade flows because they make the good or service they are applied to more expensive for consumers or businesses. In many cases, they are applied to imports as a protectionist method, to make the cost of a domestic good cheaper than an imported good.

Territorial Tax System: A system of taxation in which a country only collects taxes on income earned inside its borders. Under this system, profits earned by foreign subsidiaries are exempted from taxation, which provides an incentive for a company to remain headquartered in their country of origin.

LEARN MORE

Tax reform is a complicated issue, with many moving parts. We've compiled some resources to help you learn more about the tax reform debate, understand where other companies fall within the debate, and read issue-area experts' perspectives on how tax reform will affect small technology companies.

Tax Plans

- House Tax Cuts and Jobs Act
- Senate Tax Cuts and Jobs Act
- The "Big Six" Unified Framework for Fixing our Broken Tax Code
- Trump Administration Goals for Tax Reform

Tax Terms

- Pass-throughs: don't forget them.
  - Know the facts
  - Learn the lessons from states' examples
- What is a BAT?
  - Here's another explanation.
  - Two American coalitions explain who is for and against BAT.

Industry Perspectives

- App Association hot take: Why Repatriation Will Help Small Businesses
- App Association blog: Everyone's Talking Tax Reform, But What Does It Mean for Us?
- App Association blog: Small Businesses Rejoice: House Introduces Bill to Clarify Tax Audits and Establish More IRS Protections
- CEETA Coalition: Working to Correct Concerning IRS Auditing Practices

The people who know their stuff:

- Tax Foundation
- Tax Policy Center
- Brookings Institution: Taxation
- Committee for a Responsible Federal Budget: Taxes

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