Key tax developments for the manufacturing sector

December 14, 2020

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Disclaimer

The information provided herein is educational in nature and is based on authorities that are subject to change. You should contact your tax adviser regarding application of the information provided to your specific facts and circumstances.

R&D Tax Credit Update

What's New?

December 14, 2020

Shelby Ford
National Tax Office Partner / R&D Practice Leader

Your presenter

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R&D Tax Credit - What Qualifies?

Permitted Purpose

Product, Process, Technique, **Software**, Formula, Invention

Technological in Nature

Technical Uncertainty

Process of Experimentation

How to Estimate Credit Potential

Estimated Potential QREs x 6%

- Federal Range 5% - 8%
- Additional State Benefits Possible

Potential QREs

WAGES = Potentially Qualifying Headcount × Portion of Qualifying Time × Taxable Wages

SUPPLIES = Qualifying Project Consumables (Prototypes, Tools, Supplies, etc.)

CONTRACTOR = Qualified Project Third Party Research (US) × 65% Statutory Rate

COMPUTER RENTAL = Payments for Computer Rental Services (Azure, Amazon Web Services, Cloud costs) for Qualified Projects

Manufacturing Sub-Industries That Often Qualify for R&D Credits

- Aerospace
- Food Science
- Tool & Die Maker
- Metals, Oils, and Gas
- Automotive Manufacturers and Suppliers
- Chemical
- Appliance & Consumer Goods
- Medical Devices/Equipment
- Life Sciences and Pharmaceutical
- Packaging

M&D Trends

Nothing New (Still Qualifies)

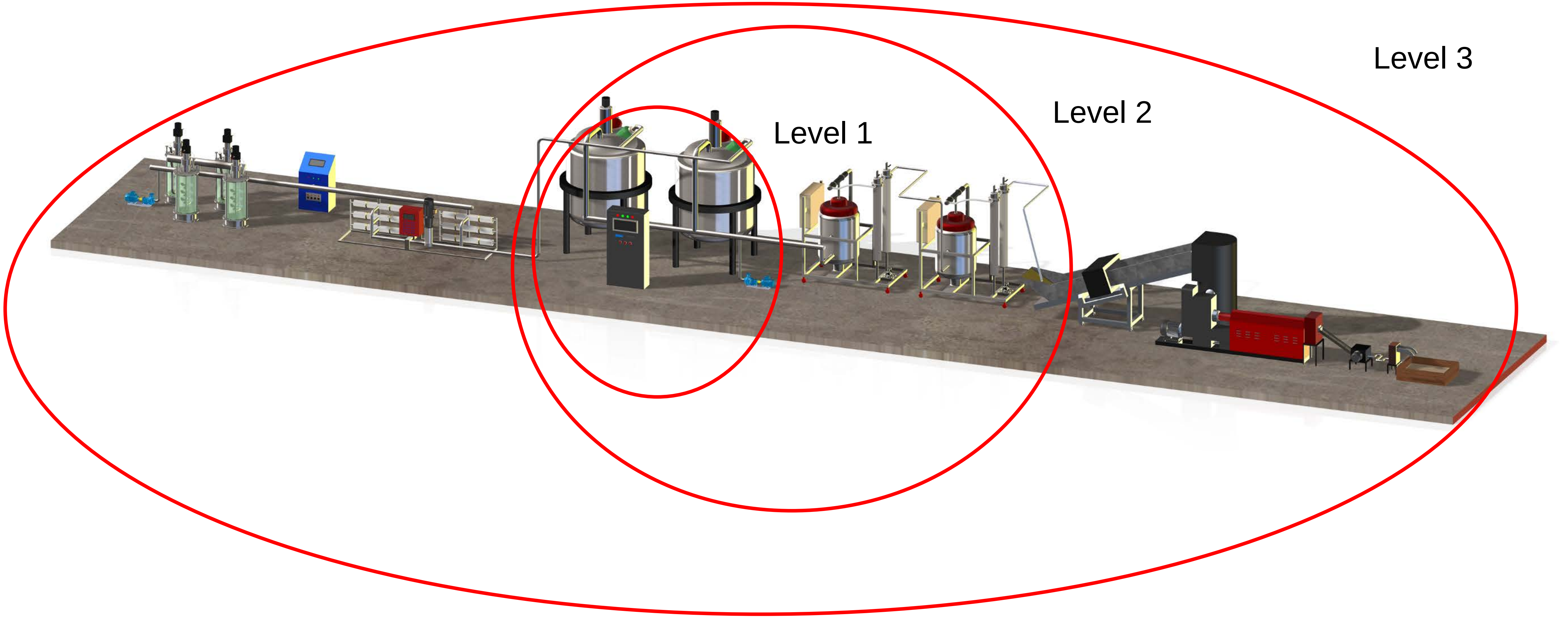
- New Product Development
- Product Enhancement
- Tooling Development
- Packaging Development
- Product Consolidation
- 3D Printing

Newer Qualifying Positions

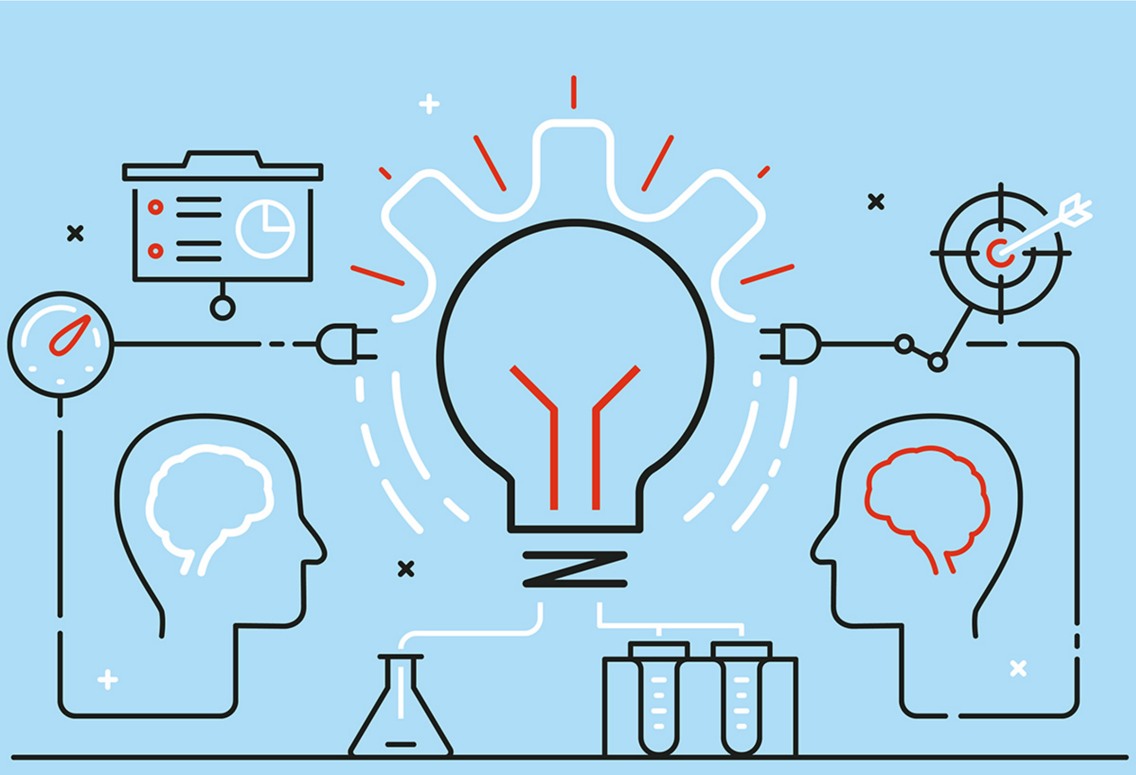
- Prototypes / **Pilot Models**
- **First-in-kind Equipment**
- **Industry 4.0**
- Artificial Intelligence
- Automation/Robotics
- Cognitive Manufacturing
- Pilot Lines

Pilot Model Position

First-in Kind Equipment - Where is the 4-part test met?



Industry 4.0



- By now, this new data- and technology-driven revolution, powered by artificial intelligence and machine learning, is emerging in every industry sector." –Forbes

- "…century's worth of technological advancements will happen over the next five years." – Ryan Daws, TechForge Media

LB&I Roundtable

- On 11/5/20, the LB&I hosted a “roundtable” event
- Top 10 firms, including Crowe, submitted comments

- Themes:
  - All-encompassing IDRs that are not specific
  - Never-ending exam cycles with no concrete feedback
  - Reliance on engineers / SMEs
  - More time spent on “obvious R&D” which will not result in material adjustments
  - Review not completed at exam level, often results in Appeals

ASC 730 “Safe Harbor” LB&I Directive

- In September 2017, the IRS released a directive to provide taxpayers with an administrative solution for identifying R&D credit eligible expenses that are accounted for in accordance with ASC 730 for financial reporting purposes.

- **Requirements**:
  - $10M+ in assets
  - GAAP audited Financial Statements
  - ASC 730: R&D separately stated/footnote

LB&I Directive – Clarifying Guidance

- Clarifying language issued September 10, 2020 for tax years ending *after* 7/31/2020. This is additive to 2017 LB&I Directive language.

- Key Changes:
  - Removes allusion of safe harbor
  - More autonomy to audit teams around eligibility and enforcement
  - Excludes some software costs
  - Additional documentation requirements

Section 174 & Software Development Expenses

- Tax years beginning *after* December 31, 2021
  - R&D conducted in the U.S. – capitalize and amortize over 5 years
  - R&D conducted outside the U.S. – capitalize and amortize over 15 years
- Considerations
  - Accounting systems for R&D costs
  - Section 174 Costs are more broadly defined than Section 41 QREs
  - Impacts foreign tax credit calculation
  - 174 costs are exempt from UNICAP

Thank you

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Transfer Pricing Considerations for President-Elect Biden's Tax Proposals

December 14, 2020

Barry Freeman, Ph.D
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Relevant Proposed Changes

Proposed Changes Impacting Multinational Corporations

Some of the key proposals affecting international businesses are focused on penalizing offshore earnings while promoting onshoring functions and jobs. A summary of these proposals is as follows:

- Increasing the U.S. corporate income tax rate from 21% to 28%.
- Establishment of an Offshoring Tax Penalty (10% surtax):
  - ➢30.8% tax will be assessed on profits of any production by a United States company overseas that is sold back into the U.S.
  - ➢Offshoring Surtax will also apply to call centers or services by American companies located overseas but serving the U.S.
  - ➢Deductions and expensing write-offs for offshoring jobs or production will be denied.
- Creation of new “Made in America” Tax Credit.
  - ➢10% advanceable tax credit for companies making investments that will create jobs for American workers.
- Closing Offshoring Loopholes created by the 2017 Tax Cut and Jobs Act (TCJA):
  - ➢Increase the effective tax rate on Global Intangible Low-Taxed Income (GILTI) from 10.5% to 21%.
  - ➢Eliminate exemption for 10% return on average adjusted basis of Qualified Business Asset Investments (“QBAI”).
  - ➢Assess GILTI on a country-by-country basis.
- Not mentioned – Foreign Derived Intangible Income (FDII) and Base Erosion and Anti-Abuse Tax (“BEAT”)

Transfer Pricing Considerations

Transfer Pricing Considerations

Like most aspects of the TCJA and President-elect Biden's proposed changes, the answer to any question about future behavior depends on multiple factors to determine the exact impact.

- GILTI
  - ➢Adjusting the transfer price to a different point in the range (higher or lower depending on the transaction) would reduce the profitability of a CFC and the amount subject to GILTI.
  - ➢Given that GILTI income may be effectively taxed at 21% rather than 10.5%, an MNC must consider whether reducing CFC income is the appropriate response. Can the MNC fully utilize its foreign tax credit?
  - ➢Similar considerations apply for location of IP and new capital expenditure
- FDII
  - ➢No discussion of whether FDII benefit would remain President-elect Biden's plan but seems to be consistent with overall policy – with some modifications (likely through Executive Order or temporary regulatory freeze).
  - ➢If FDII benefit remains, income from eligible foreign sales would be taxed as low as 17.5%
- BEAT
  - ➢No discussion of BEAT under President-elect Biden's plan but rumors that $500 million threshold would be reduced.
  - ➢Adjusting the transfer price to lower the markup would reduce the amount subject to BEAT.

Thank you

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Wayfair update practical application for M&D

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South Dakota v. Wayfair, 138 S. Ct. 2080 (2018)

- 5-4 decision to overruled *Quill* physical presence standard for sales tax nexus (note: both *Quill* and *Wayfair* are use tax cases).

- Supreme Court invalidated physical presence rule set forth in *Quill Corp v North Dakota,* 504 US 298 (1992). Physical presence was "unsound and incorrect" WHEN DECIDED.

  - The physical presence rule is not required for substantial nexus.
  - *Quill* created market distortions.
  - *Quill* imposed arbitrary, formalistic distinction.

South Dakota v. Wayfair (2018)

- **Factors identified by the Court in *Wayfair* in South Dakota statute that prevented discrimination or undue burdens upon interstate commerce.**
  - No retroactivity
  - Member of Streamlined Sales and Use Tax Agreement (Centralized Administration of Tax)
  - De Minimus/Minimum threshold
- **Consider future Commerce Clause precedents: protections against undue burden on interstate commerce.**
  - Pike balancing test. *Pike v. Bruce Church, Inc*., 397 US 137 (1970)
  - Compare burden on interstate commerce with benefits provided by the taxing state.

Income Tax Issues Post-Wayfair

- Avoiding undue burden
  - The United States Supreme Court identified three features of the South Dakota statute that appeared designed to prevent undue burden in the context of sales/use tax
    - De minimis thresholds
    - No retroactive application
    - A degree of uniformity across states (Streamlined)
  - How do these issues apply to Income Tax Statutes?
- P.L. 86-272 Considerations

Factor presence economic nexus for income/franchise

Updated November 2, 2020

• **MTC** –2002 – substantial nexus is established if any of the following thresholds are exceeded during the tax period: • $50K of property, • $50K of payroll, • $500K of sales, or • Any of the above is over 25% of the total. • **AL** – 2015 – uses the MTC model • **CA** – 2011 -- $61,040 for payroll or property; $610,395 for sales; or the same MTC 25% test for any factor • **CO** – 2010 – uses the MTC model • **CT** – 2010 – $500K sales, unless Public Law 86-272 immunity applies	• **HI – 1/1/2020** – uses the Wayfair limits - $100K in sales or 200 or more transactions in the current tax year • **IN – ???** – has not issued any bright line guidance but in 2019 IN changed a statute which may indicate sales alone can create substantial nexus • **MA – 10/18/2019** – $500K in virtual and economic contacts create nexus • **MI** – 2007 - $350K plus active solicitation in Michigan	• **NV** – 2015 – Commerce Tax -- $4,000K • **NYS** – 2014 – $1,000K, unless Public Law 86-272 immunity applies • **OH** – 2005 – Commercial Activity Tax (CAT) The OH CAT passed judicial challenge at the OH Supreme Court level in 2016…parties settled before it went to the US Supreme Court. • **OR– 01/01/2020** – Corporate Activity Tax -- $750. This gross receipts tax is in addition to the corporate income tax	• **PA – 1/1/20** -- $500K, unless Public Law 86-272 immunity applies • **TN** – 2016 – uses the MTC model, unless Public Law 86-272 immunity applies • **TX – 12/29/2019** -- $500K • **VA** – 1950 – no limits identified, claims economic nexus based on their law. One statute says "…and every foreign corporation having income from Virginia sources." • **WA** – 2010 – Business & Operations (B&O) -- $100K • **Various Cities** (e.g., Philadelphia – 1/29/2019 -- $100K; San Francisco, Los Angeles, etc.)

Thank you

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Net Operating Losses and Tax Planning

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NOL’s and Tax Planning

Net operating loss (NOL) carrybacks

- The CARES Act temporarily provides a five-year carryback of NOLs incurred by corporations and individuals in the 2018, 2019, and 2020 tax years eliminated by TCJA for businesses and individuals.
- Consider accounting method changes to create or increases a NOL in 2020, it can be carried back to refund taxes at a 35% rate instead of taking deductions at the current 21% rate.
- Because 5 year carryback only available through the 2020 tax year, this opportunity expires in 2021.

OPPORTUNITY

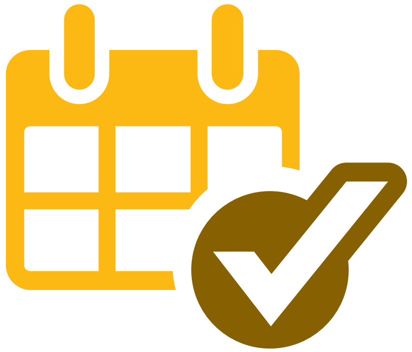
- Defer income from 2020 to increase NOL to carryback to higher tax rate pre 2018.
- Accelerate expenses in 2020 to increase NOL to carryback to higher tax rate pre 2018.

ACCOUNTING METHODS & RELATED CHANGES

- Implemented by filing a Form 3115, *Application for Change in Accounting Method.*
- Results in change of <u>timing</u> for recognizing income / expenses.
- Automatic method changes under Revenue Procedure 2019-43

Common Automatic Method Changes

1. Depreciation & Amortization
2. Internally Developed Software
3. Self-Insured Employee Medical Benefits (IBNR)
4. Prepaid Expenses
5. Deferral of Advance Payments (Receipts)
6. Cash to Accrual for Certain Items
7. Rebates & Allowances (Application of Recurring Item Exception)
8. Accrued Taxes (Application of Recurring Item Exception)
9. Tangible Property Rules



Inventory Changes

COMMON AUTO CHANGES (§471)	COMMON AUTO CHANGES (§263A)

• Valuation Methods
  • Impermissible to Permissible
  • Permissible to Permissible
  • Rolling Average
• Discounts
  • Cash Discounts
  • Trade Discounts
  • Advance Trade Discounts
• Estimating Inventory “Shrinkage”
• Small Taxpayer Exception
	• Methods Used by Resellers/Reseller-Producers
	• Methods Used by Producers/Reseller-Producers
	  • Modified Simplified Production Method
	• Sales Based Royalties
	• Small Taxpayer Exception

Thank you

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Post-Election Outlook: Selected Provisions

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Post-Election Outlook for 2022 Changes

Provisions	Levers

• IRC §163(j) change to compute adjusted taxable income without adding back depreciation and amortization effective 1/1/22 (JCT lists as expiring in 2021)
• Bonus depreciation phase out starting 1/1/23 (JCT lists as expiring in 2026)
• IRC §174 capitalization and 5 year amortization requirement 1/1/22
	• Outcome of the Georgia Senate races
	• Whether there is an extender package this year, and if so, what's included
	    • Craft beverage excise tax could drive push for other extenders
	• Taint of TCJA funding mechanism
	• Bipartisan support for R&D
	• Negotiating chip for 2026 cliff, priorities of Democrats
	• More bites at the apple:
	    • 2021: Stimulus, debt ceiling, appropriations, other?
	    • 2022: Retroactive relief? Outcome of 2022 congressional election

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