

Winning Tax Strategies in a Recovering Economy

Presented By:

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Objectives

- High level look at some of the strategies Manufacturers all over Central PA and beyond have been using to mitigate or defer tax liability
- Understanding of good candidates for each strategy as well as limitations
- Action items for each strategy that may apply



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Agenda

Winning Tax Savings Strategies in a Recovering Economy:

1. Maximizing DPAD
2. IC DISC
3. Research & Development Tax Credits
4. Cost Segregation
5. IPIC LIFO
6. Other (time permitting)
7. Questions

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Maximizing DPAD

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Maximizing DPAD

- Incorrectly called “The Manufacturer’s Credit”
- Broader than manufacturing but a definite tax subsidy for manufacturers
- 3% of qualifying net income 2005-2006
- 6% of qualifying net income 2007-2009
- 9% of qualifying net income after 2009
- Deduction is sometimes overlooked altogether and often oversimplified by Companies – failing to maximize the benefit afforded

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Maximizing DPAD

- High level overview of qualifying activities
- For manufacturers – deduction applies to lease, rental, license, sale, etc. of personal property MPGE (manufactured, produced, grown, or extracted) in whole or significant part in the US.
- US activity must be “substantial in nature” or meet a 20% safe harbor (direct labor and overhead in US account for 20% of cost).
- Many exceptions and holes – including 263A failures and Contract Manufacturing situations

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Maximizing DPAD

- Missed Opportunities
- Failure to Identify qualifying activities
- Failure to allocate expenses between qualifying and non-qualifying activities in the most favorable fashion
- Missing “special” exceptions (i.e. the “Starbucks Footnote”)
- Failure to use the 5% safe harbor
- Inefficient entity structuring and owner compensation strategies (primarily for pass-through)

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Action Items

- Review tax return – Is DPAD income equal to 9% of taxable income before DPAD? Should it be based on your knowledge of the business? See form 8903 for C corps or schedule K information for pass-through entities.
- Examine profitability of qualifying vs. non-qualifying activities.
- Evaluate how owners are compensated for pass-through entities.
- Consult your tax adviser

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Tax Savings for Exporters Utilizing an IC-DISC

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Export Incentive History

- 1971 – Domestic International Sales Corp. (DISC). *Allowed exporters to accumulate profits inside the DISC without paying taxes until distributed*
- 1984 – DISC regime challenged as an illegal export subsidy
- 1984 – Foreign Sales Corp. (FSC) *Allowed partial tax exemption if exporters formed a foreign corporation – DISC changed to IC-DISC*

(Interest Charge Domestic International Sales Corporation)

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Export Incentive History

- 2000 – FSC Repealed. Extraterritorial Income (ETI) enacted. *Allowed all exporters a benefit by excluding a portion of profits from export income*
- 2004 – ETI repealed

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What's Left for Exports?

Today: the Interest Charge Domestic International Sales Corporation (restructured in 1984 as IC-DISC) remains unchallenged and available.

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IC-DISC overview

- In essence, an opportunity for tax rate arbitrage for exporters
- Converts a portion of ordinary income into “qualified dividends.”
- Requires some company restructuring that must be accomplished before savings can start to accrue.

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Taxation of IC-DISC and its Shareholders

- IC-DISC is not taxed on its income for Federal tax purposes.
- The related exporter takes a deduction for the IC-DISC commission paid or accrued
- The shareholders of the IC-DISC are taxed on deemed or distributed dividends (as qualifying dividends)
- An interest charge may apply to the shareholders if the IC-DISC has accumulated income in consecutive years

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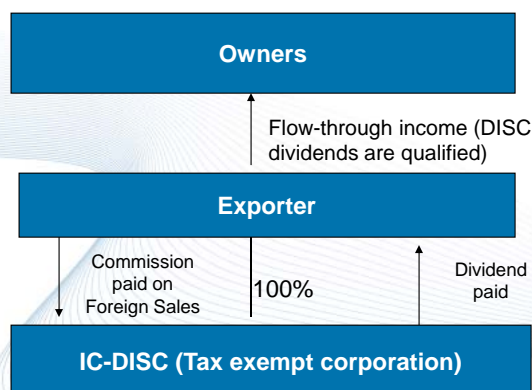
Structuring the IC-DISC

- An IC-DISC may either be a subsidiary of a passthrough or a brother-sister entity of a pass-through (S corp, LLC, partnership)
- An IC-DISC **must** be a brother-sister company of a C Corporation (limits strategy for C corps to closely held C corporations)

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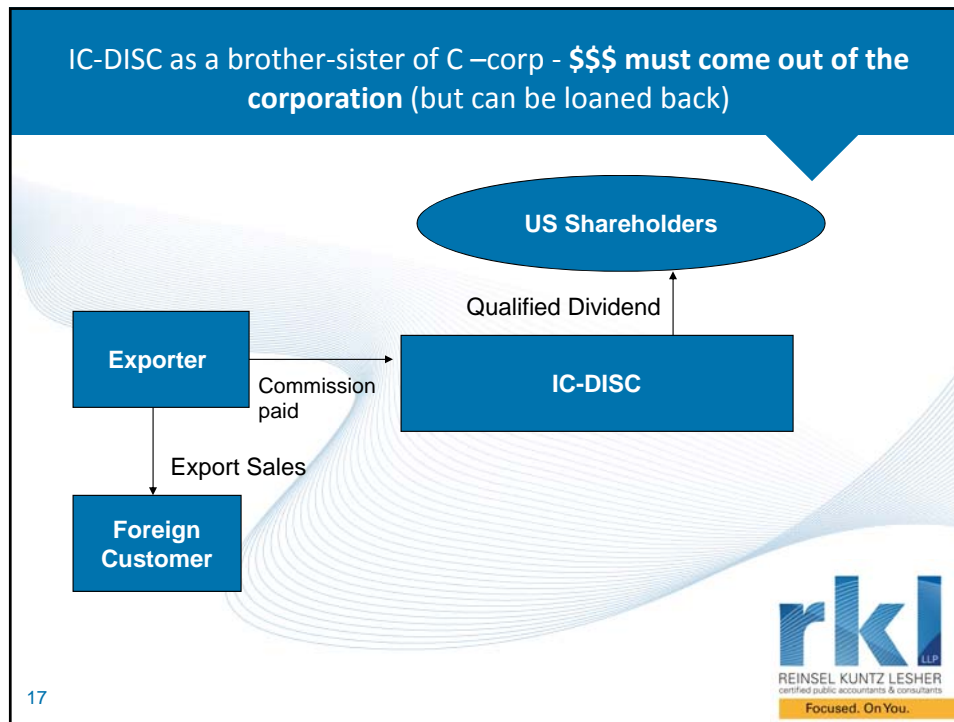


IC-DISC as a Subsidiary of Passthrough – \$\$\$ Stays in Corporation



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How is the commission calculated?

- The IC-DISC commission is the greater of:
 - 4% of qualified export receipts, or
 - 50% of combined taxable export income or
 - Taxable income based on sales price charged
- Commission cannot exceed the combined taxable export income
- Combined Taxable Income
 - Calculated with fully loaded expense allocation
 - Can use general or specific allocation

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IC-DISC Benefit to Passthrough Exporter

	No IC-DISC	IC-DISC
Export Profits	\$10,000,000	\$10,000,000
Commission (50% profits)	N/A	5,000,000
Income taxed @ 39.6%	10,000,000	5,000,000
Income taxed @ 23.8%	N/A	5,000,000
Total Tax	\$ 3,960,000	\$ 3,170,000
Overall ANNUAL Tax Savings		\$ 790,000

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Qualifying export property

- Property MPGE in the US
- Sold, leased, or rented or “ultimate disposition” outside of the US without further manufacturing outside of US
- 50% US Content Rule
- Not one of 5 types on specified non-qualifying property (IP, softwood timber, oil or coal subject to depletion, related party sales, POTUS designated short supply property).

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Action Items

- Determine if your entity structure can benefit
- Analyze export sales (including Canada) using the “ultimate destination” criteria.
- Over \$1,000,000 of export sales or over \$80,000 of export profits is a soft floor
- Determine if export property qualifies
- Cost benefit analysis
- Consult your tax adviser

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Research & Development Tax Credits

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Quick Overview of Code Sections 174 and 41

- The Research Credit is a direct reduction of an entity or shareholder's tax liability (source income, taxable income and AMT tax limitations apply)
- The regular federal credit is 20% of Qualified Research Expenses ("QRE") in Excess of a Base Amount Limitation
- Regular Credit
 - Full Credit (20%) vs. Reduced Credit (13%)
- Alternative Simplified Credit
 - New for 2007 and forward
 - 14% of amount by which current year QRE's exceed 50% of the prior three year average QRE's

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Quick Overview of Code Sections 174 and 41

- States allow research credits, however, state law must be reviewed to determine conformity to federal law and specific non-conformity issues
- Pennsylvania's R&D Tax Credit
 - State funds allocated to the credit pool available to companies increased to \$55 million and \$11 million for small companies

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Quick Overview of Code Sections 174 and 41

Generally, four requirements to meet for a project or activity to qualify:

- Research must be performed for the purpose of **eliminating uncertainty**,
- Research expenses must use a **process of experimentation** designed to achieve a result where capability, method or design of the result is uncertain at the outset of the research,
- Research must be undertaken for the purpose of discovering information that is **technological in nature** (using principals of computer, engineering, chemistry or physical sciences), and;
- Research must be undertaken to develop a new or improved **business component**.

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Quick Overview of Code Sections 174 and 41

Expenses that **do not** qualify for deductibility under IRC 174 are expense related to:

- Ordinary testing or inspection for quality control
- Efficiency surveys
- Management studies or activities
- Consumer surveys
- Advertising or promotions
- Acquisition of another's patent, model, production or process
- Research in connection with literary, historical or similar projects (social sciences)
- Management function or techniques developed for internal use

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Quick Overview of Code Sections 174 and 41

Activities that **do not** qualify for the credit under IRC 41:

- Activities not directed at functional aspects of a product (typically, this includes expenses relating to style, taste, cosmetics, etc.)
- The adaptation of existing business component to a particular requirement or customer need where no uncertainty element exists (custom product development does qualify, i.e. job shop, etc.)
- Duplication of an existing business component (reverse engineering)
- Routine data collections
- Funded Research (i.e. by grant, contract or other)
- Research performed outside of the United States

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Quick Overview of Code Sections 174 and 41

Activities that **qualify** for the credit include:

- New Product Development
- Product Improvements
- Process Improvements
- Software Development (special rules apply)

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Quick Overview of Code Sections 174 and 41

Costs that **qualify** for the credit

- **Wages**, excluding any fringe benefits, of employees directly engaged in the research, or that provide direct supervision or support of the research. This amount can be found on line 1 of the form W-2.
- **Supplies**, excluding land and depreciable property. These supplies must be consumed in the performance of the research activities. Examples include cost of fabricating prototypes and raw materials consumed during testing.
- **Outside services** incurred during the research process. Only 65% of these costs are eligible for the credit. These costs include outside consultants, software programmers and engineers, outside tool and die makers, special testers, etc.



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Quick Overview of Code Sections 174 and 41

Simple Illustration of R&E Credit Calculation for Alternative Simplified Credit

Qualified Costs (QRE)	\$100,000
Average of prior three years QRE	80,000
50% of average of prior three years QRE	40,000
Current year QRE less 3 year average QRE	\$60,000
Federal Research Credit (14%)	\$8,400
Reduced Credit Amount (reduced 35%)	\$5,460



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Action Items

- Determine if Company has activities that would be considered R & D
- Estimate costs and compare to prior 3 years
- Determine if Company or shareholders can benefit from the credit
- Educate employees
- Set up documentation protocol
- And of course.....consult your tax adviser

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Tax Savings for Manufacturers Using Cost Segregation Studies

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Cost Segregation

- Creates tax benefits through accelerated depreciation – IRS prescribed life for buildings is 39 years
- Allows for easier write-off of assets when broken or obsolete
- Increases cash flow in early years of project
- Better matching of debt service with tax deduction, eliminating “phantom income.”

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Cost Segregation

- Where does it apply
 - Construction of New Building
 - Renovation or Expansion of Current Facility
 - Purchase of a Building
 - Renovations Made to Building you are Leasing
 - **Existing building in service for which a study was not previously performed (catch-up depreciation all deductible in the year of study)**

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Cost Segregation

Typical % of building assets that can be reclassified into shorter lived property:

Hotels and motels:	20%-40%	Nursing Homes:	15%-30%
Auto dealers:	15%-30%	Medical offices:	20%-35%
Casinos:	20%-35%	General office:	15%-25%
Retail:	10%-40%	Banks:	15%-30%
Restaurants:	15%-40%	Multi-Unit Resid.:	15%-25%
Light Manufacturing:	15%-40%	Processing Plants:	60%-90%
Heavy Manufacturing:	25%-70%		



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Cost Segregation - Sample

- \$10,000,000 building for metal stamping and fabrication company placed in service in 2013
- 10% reclassified to 15 yr property; 25% reclassified to 7 year property through cost segregation



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Cost Segregation - Sample

- Additional depreciation – first 8 years = \$2,384,000 (excludes bonus depreciation)
- Deferred taxes at end of year 8 at 40% = \$953,600
- NPV of tax deferral over 40 years = \$590,000

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Action Items

- Review depreciation schedules for assets depreciated over 39, 31.5 or 27.5 years
- Determine if personal property and/or land improvements are being depreciated as separate assets or are included in the long-lived assets
- Recalculate depreciation based on estimated benefits
- Calculate depreciation catch up and NPV of depreciation deductions
- And naturally.....consult your tax adviser

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Tax Savings for Manufacturers using the IPIC LIFO Method for Inventory

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Inventory Accounting

FIFO – “First In - First Out”

LIFO – “Last In - First Out”

Using LIFO accounting allows you to count inventory using the oldest inventory prices in your inventory “pool”

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IPIC LIFO Inventory Accounting

- LIFO inventory accounting is generally cumbersome, particularly for manufacturers with many inventory SKUs
- Enter IPIC LIFO – “inventory price index computation method” of LIFO accounting
- Allows taxpayers to use nationally published PPI and CPI indices to determine their inventory inflation, regardless of actual internal inflation costs
- This method greatly reduces the complexity of LIFO accounting and allows significant tax deferrals for products with high inflation

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IPIC LIFO Inventory Accounting Sample Inflation

Commodity Description	Annual average inflation for last 10 years ended 12/14
Hides & skins	5.5%
Processed eggs	8.9%
Prepared animal feeds	6.6%
Tobacco products	5.1%
Flour	6.0%
Nonferrous metal ores	8.3%
Construction sand, gravel, stone	4.6%

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IPIC-LIFO-Sample Calculation Rubber & Cork

Year	Blended Inflation –PPI – Rubber and Cork	Inventory @ FIFO	Inventory @LIFO	Annual deferred income	Cumulative deferred income
12/2012	1.2%	15,147,347	10,000,000	179,613	5,147,347
12/2011	10.6%	14,967,734	10,000,000	1,434,521	4,967,734
12/2010	4.0%	13,533,213	10,000,000	520,508	3,533,213
12/2009	-2.4%	13,012,705	10,000,000	-319,985	3,012,705
12/2008	9.7%	13,332,690	10,000,000	1,178,916	3,332,690
12/2007	3.2%	12,153,774	10,000,000	376,861	2,153,774
12/2006	4.0%	11,776,913	10,000,000	452,958	1,776,913
12/2005	4.8%	11,323,954	10,000,000	518,654	1,323,954
12/2004	4.5%	10,805,300	10,000,000	465,300	805,300
12/2003	3.4%	10,340,000	10,000,000	340,000	340,300

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IPIC LIFO - Constraints

- Financial Statement Conformity Rule
- Deflation
- LCM (lower of cost or market) not allowed, must give up any LCM reserve and record at cost
- IFRS (International Financial Reporting Standards) convergence
- Legislative repeal?

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What is this number?

\$10,600,000,000

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Action Items

- Look for inflation trends in company inventory
- Examine volatility expectations
- Consider drawbacks
- Consult your tax adviser

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Other Tax Planning ideas

- Accounting method optimization (IBNR, pre-paid expenses, TARS, 263A, etc.)
- Analysis of perm differences (M & E exceptions, etc.)
- Micro-captives (831(b))
- Executive compensation strategies
- Tax advantaged entity structuring

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Questions?

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Winning Tax Strategies in a Recovering Economy

Frank Tobias
Principal, Tax Services Group



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State Trends

- **Nexus**
 - Economic
 - Exploiting or Directing the Market
 - Agency
 - Activities linked to those of a related company or other “agent”
 - See MTC Whitepaper 95-1
 - Scripto



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State Trends

- **Nexus**
 - Affiliate
 - Generally, nexus by virtue of interest in another entity
 - Bright-line nexus standards/Factor Presence test
 - MTC model statute, CA, NY
 - There is still P.L. 86-272 protection for solicitation of sales of TPP

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State Trends

- **Increased weighting of sales apportionment factor**
 - Three factor
 - few states left
 - Single-sales factor
 - 17 states
 - Double-weighted sales factor (with 3 factor formula)
 - 16 states

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State Trends

- **Increased weighting of sales apportionment factor**
 - Sourcing of sales from services and intangibles
 - 15 Market Based States
 - 18 Cost of Performance (COP) States
 - “All or Nothing”
 - 12 Cost of Performance States
 - Proportionate

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State Trends

- **Apportionment Issues:**
 - MTC states/UDITPA – Is 3 factor still the standard?
 - *Gillette* [CA], *IBM* [MI]
 - Retroactive law change?
 - Opens the statute for everyone!
 - Pass Through entities
 - At partner or partnership level?
 - G/L 's included or excluded
 - Gross or Net
 - BI or NBI
 - Sale of interests – intangible?

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State Trends

- **Apportionment Issues:**

- Sales of Services

- UDITPA says to use COP
 - More challenges to market based sourcing
 - More withdrawals from the MTC [adopts UDITPA]

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State Trends

- **Alternative Apportionment**

- Alternate factors
 - Does method fairly reflect the level of business in the taxing jurisdiction
 - Activity specific methods (transportation)
 - Industry specific methods (banks, finance companies)
 - *Vodafone v. TN* App. Ct. Allowed Revenue Commissioner to impose “alternative” method (Mkt based) instead of COP for services

Allowed only in “unique and nonrecurring” circumstances

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State Trends

- Mobile Workforce Act
 - 30 day minimum
- Expansion of P.L. 86-272
 - De minimis defined
 - 14 day exception for services
 - Trade Shows
 - Deliveries
 - TX decision 107,751 (7/23/14) “Trailing Nexus” lasts for 12 months

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State Trends

- Remote seller reporting obligations
- Required seller disclosure of information
 - RI, MD, TX – Corp Tax
 - OK, CO, AZ – Sales Tax
- ASC 740 (formerly FIN 48)
- Gross Receipts Taxes

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State Issues – Transfer Pricing

- State transfer pricing audits appear forthcoming, as the MTC is set to launch a project which will draft a program by year's end
 - Intent
 - Advisory group outlines
 - Draft due date: December 2014
 - Final Design due date: July 2015

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State Issues - Transfer Pricing

Concerns:

- States do not understand Section 482
- Abuse is likely, more borne out of ignorance than anything else
- How far reaching?
 - Challenging intercompany sales prices
 - Management/Cost sharing agreements
 - What about A/R Factoring companies?
 - What about all other expenses to related parties (REITs, RICs, Captives,.....)

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Tax Planning Strategies

- State and local taxes
 - Tax methodology differences
 - Frequent changes
- Understanding your tax position(s) is critical to managing cash flow, implementing compliance controls and mitigating risk/liabilities
 - Rapid Growth
 - Expansion
 - M&A
 - Diversification

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Tax Planning Strategies “In Chaos there’s Opportunity”

M&A

- Where, how and why does the target do business and are they compliant with all liabilities
- What is their past SALT audit history like
- Is the company in “good standing”
- What is the tax treatment of the deal

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Tax Planning Strategies

“In Chaos there’s Opportunity”

Significant corporate transactions

- Does the SALT jurisdiction strictly adopt federal treatment
- Is it a separate company or unitary state and how does that affect SALT treatment
- How do we source and/or apportion income/losses
- Does the jurisdiction acquiesce or totally divest of federal treatment
- What are the SALT tax consequences of the transaction
 - Sales tax, property tax, gross receipts taxes...

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Tax Planning Strategies

Minimization of corporate income tax nexus with unfavorable taxing jurisdictions: 3 Methods

1. Segregating activities from income producing operations and/or separately incorporate certain portions of the business
2. Creating a pass-through entity
3. Creating an intangible holding company to license out the intellectual property of the corporation

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Tax Planning Strategies

Special Purpose Entities

- Intangible Holding Companies
- Transportation Companies
- Factoring Company
- Internet Sales Company
- Procurement Company

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Tax Planning Strategies

Special Purpose Entities

- Operations:
 - Separate sales company and/or Internet sales company
 - Install companies
- Benefits:
 - Apportionment methods
 - Mitigate nexus
 - Isolate revenue in lower tax rate jurisdictions
 - Sourcing of receipts (services vs. TPP)

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Tax Planning Strategies

Special Purpose Entities

➤ Activities:

- Transportation Company
- Factoring Company
- Procurement Company

➤ Benefits

- Special exemptions or exclusions
- Apportionment and sourcing
- Income shifting

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Tax Planning Strategies

Special Purpose Entities

• Intangible Holding Companies –

➤ Moving company-owned assets that generate certain significant revenue stream to entities located in states that do not tax these revenue streams.

- Is the DHC still viable?
 - PA legislation
 - Rebuttable presumptions still exists
 - Income “directly” related to intangibles
- Separate finance company?

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Tax Planning Strategies

Special Purpose Entities

➤ Transportation Companies -

- Moving fleet operations into a separate carrier to enhance liability protection for the operating company/owners and take advantage of significant sales tax exemptions.

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Tax Planning Strategies

Special Purpose Entities

➤ Factoring Company -

- Sales of receivables at an arms-length discounted rate to a factoring company in certain taxing jurisdictions can achieve state tax savings.

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Tax Planning Strategies

Special Purpose Entities

➤ Internet Sales Company –

- While the advent of the SSTP and efforts by some states are attempting to attack internet businesses, there are still opportunities to reduce sales tax nexus and compliance burdens while both improving efficiencies of sales operations and improving the ability to more easily reach an expanded customer base using an Internet Sales Company.

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Tax Planning Strategies

Special Purpose Entities

➤ Procurement Company –

- While there are certain income tax advantages to leasing business property, the use of a purchasing company may also improve the ability to defer or, in some cases, reduce the sales tax expense associated with turning over business assets.

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SALES AND USE TAX

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SALES and USE TAX Compliance

- Responsibility for Sales and Use Tax
 - TRUST FUND TAX
- What is Use Tax?
 - Imposed on the buyer when the seller does not collect sales tax
- Where is Use Tax paid?
 - To the state where the purchase “is used”
 - Sourcing of Services
- Exemption Certificates
- Audit Considerations
- Pursuing Credits Or Refunds

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SALES and USE TAX Nexus

- Sales tax is not protected under P.L. 86-272
- Nexus standards
 - Affiliate nexus
 - Agency nexus
 - Independent reps.
 - Sale of TPP is different than sale of services
 - Click Through Nexus - 6 states
 - MN, NC, CT, RI, VT, NJ
 - Affiliate Nexus - 10 states
 - VA, WV, TN, SC, OK, TX, IA, SD, UT, CO

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SALES and USE TAX Nexus

- Sales tax is not protected under P.L. 86-272
- Nexus standards *continued...*
 - Click Through + Affiliate Nexus - 9 states
 - **NY, PA, CA**, ME, GA, AR, MO, KS, IL
 - Remote Seller Nexus
 - 11 states
 - 5 States with no SUT
 - 9 States specifically not addressed

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Significant Exclusions (Manufacturing – Processing)

- Exclusion vs. Exemption
- Manufacturing
 - Direct use; Predominant use; Close proximity
 - Equipment
 - Realty?
- What is Processing?
- Additional Parties Entitled To Claim the Exclusion for Manufacturing
 - Co-manufacturing
 - Manufacturing of manufacturing equipment
 - Molds and dyes

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Other

- Tax Credits
 - KOZs
 - TPPR
 - Taxes paid to other states
 - Use taxes paid by purchaser
 - Returns and allowances
 - Bad debt
- Benefits of Direct Pay Permit
- Negotiated Settlements
- Utility studies
- Cost segregation studies
 - Sort of like, but opposite of, a cost seg for depreciation purposes!

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Tax Planning Strategies

Reasons to keep current in monitoring sales and use tax issues and compliance:

- Businesses are changing how they sell and buy
- Sales tax rates change constantly
- Transactions are crossing jurisdictions at an increasing rate
- 3,000 sales taxes imposed in the U.S.
- Certain activities may trigger nexus in a state
- Jurisdictional boundaries are harder to determine
- States need revenue

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Tax Planning Strategies

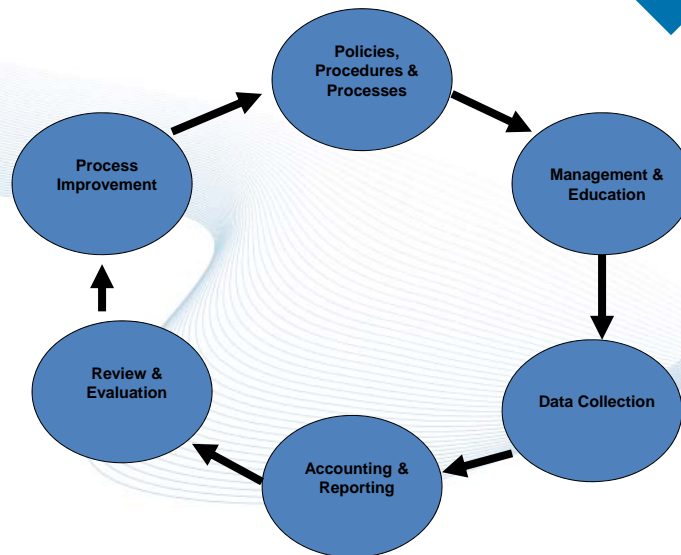
Reasons to keep current in monitoring sales and use tax issues and compliance...continued:

- Expanding list of items subject to sales tax
- The high cost of a sales tax audit
 - Cost of time spent reviewing records and responding to auditors' requests
 - Strain on internal resources and technology
 - Cost of professional assistance
 - The tax assessment itself
- Future year scrutiny

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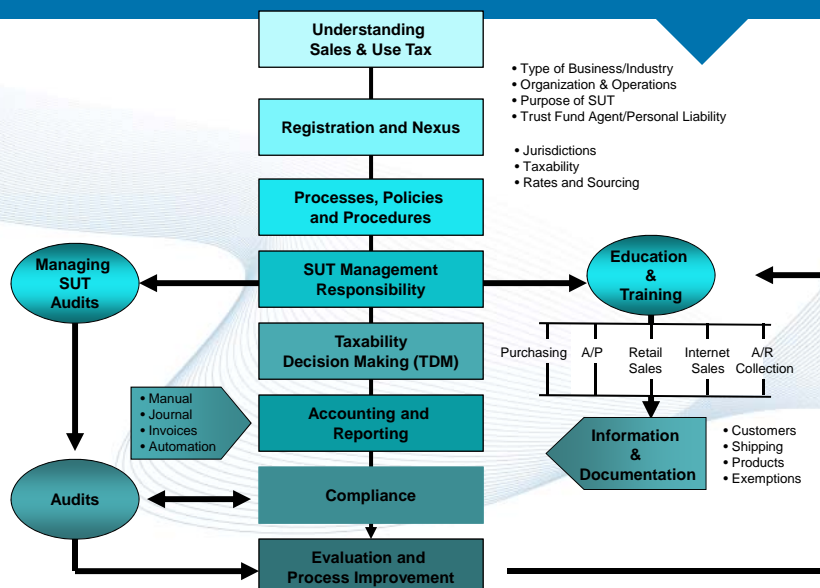


Understanding The Sales & Use Tax Cycle

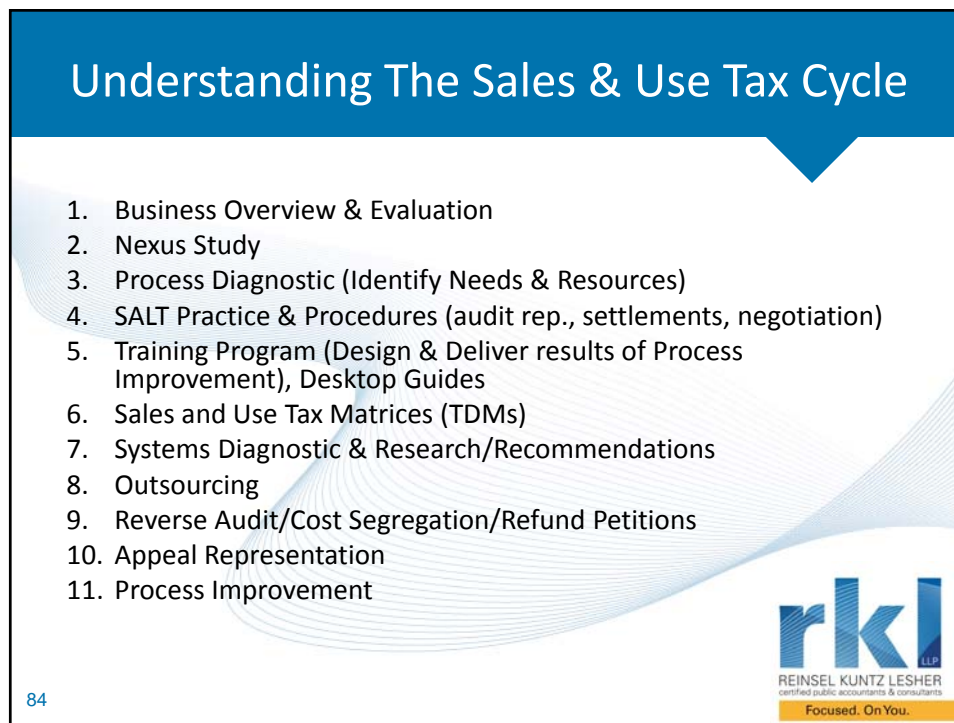
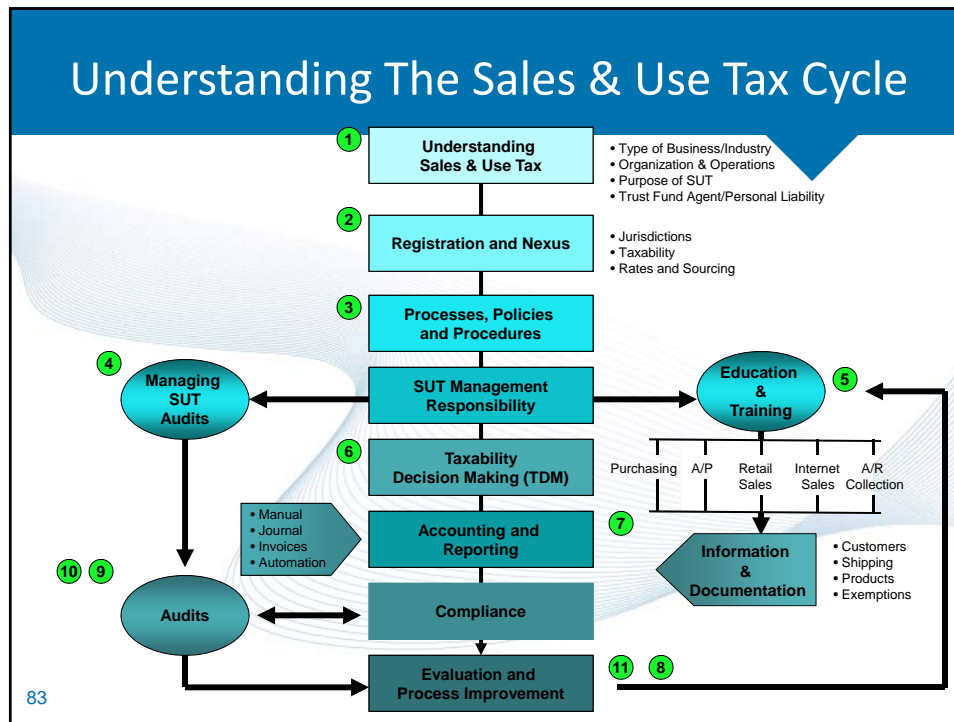


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Understanding The Sales & Use Tax Cycle



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Questions?

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