A Global Review of Tax Incentives

Research Credit and § 199

Recent Research Credit Case Decisions / Guidance

- *Suder v. Comm'r* (Tax Ct. 2014)
  -

Final Regulations Under § 41 for Computer Software Development

- Historically, Congress identified two types of internal-use software (IUS) that were the target of the original statutory exclusion from the definition of qualified research:
  - Software used to provide non-computer services
    - Accounting, consulting, banking, etc.
  - Software used to support general and administrative functions
    - Payroll, bookkeeping, personnel management, etc.
- Congress later advised Treasury to take note of the rapid pace of technological advancement and use of software by businesses to deliver services when developing regulations for IUS

Final Regulations (cont'd)

- Subsequent guidance attempted to redefine IUS in ways not considered by Congress
  - E.g., software not developed to be commercially sold, leased, licensed, or otherwise marketed to third parties, "unique and novel," comparison to the common knowledge of skilled professionals

Final Regulations (cont'd)

- The final regulations address whether R&D activities related to software is qualified research
  - The final regulations will be prospective only, applicable to tax years ending on or after October 4, 2016
  - IRS will not challenge return positions consistent with the final or proposed regulations for taxable years ending on or after January 20, 2015 (the date the proposed regulations were published) and

Final Regulations (cont'd)

- The final regulations:
  - Clarify what is internal-use software and what is not IUS
  - Provide rules related to software that is developed both for internal and non-internal uses
  - Provide guidance regarding the high threshold of innovation test
  - Provide examples of the application of the process of experimentation requirement to software development and provide rules to illustrate the application of the final rules
- IUS generally must meet additional requirements to satisfy the definition of qualified research

Final Regulations (cont'd)

- Definition of internal-use software:
  - Software developed for use in general and administrative functions
    - Financial management functions
    - Human resources management functions
    - Support services functions
- Definition of non-internal-use:
  - Software not developed for use in general and administrative functions
    - Example: Software developed to be commercially sold, leased, licensed, or otherwise marketed to third parties
    - Example: Software developed to enable a taxpayer to interact with third parties

Final Regulations (cont'd)

- Time and manner of IUS or non-IUS determination
  - The determination of whether software was developed for use in a G&A function is made based on the intent of the taxpayer and the facts and circumstances at the beginning of the development
- Definition of dual function software
  - Software that is developed both for use in a G&A function and to enable the taxpayer to interact with third parties
  - Presumed to be IUS

Final Regulations (cont'd)

- Dual function exception and safe harbor
  - To the extent a taxpayer can identify a third-party subset, such portion is not IUS
  - If the intended use by third parties is at least 10% of all anticipated use, the dual function software or subset is not IUS and the taxpayer may include 25% of the development costs
  - Intended use by third parties may be shown by any reasonable method appropriate to the taxpayer's industry
  - A taxpayer may choose not to apply either of these rules, and show that software satisfies the high threshold of innovation standard

Final Regulations (cont'd)

- Significant economic risk test
  - Commitment of substantial resources to the development and there is substantial uncertainty, because of technical risk, whether resources would be recovered within a reasonable period
    - The proposed regulations excluded design uncertainty, but the final regulations do not characterize the types of uncertainty that must be demonstrated
  - Does not define "significant," "substantial," or "reasonable"
- Not commercially available test
  - Cannot

Final Regulations (cont'd)

- Common questions:
  - If only the taxpayer's ew001 Tc 0>.508 Tm [(I)3.66.0002 50onl

Final Regulations (cont'd)

- The purpose of the regulations was to narrow the category of IUS
- Big picture: the key to determining if software is internal-use, and subject to the high threshold of innovation standard, is to evaluate the purpose for which the software development was undertaken

Statutory Changes to § 199

- Potential statutory changes
  - Revision of § 199(d)(10) — relating to contract manufacturing

Proposed Regulations (Aug. 27, 2015)

- General Provisions
  - Change in contract manufacturing rules
  - Computation of W-2 wage limitation for short tax years and tax years with business transactions (Temp. Reg.)
  - Examples on non-qualifying MPGE activities of testing and packaging, repackaging, labelling and minor assembly
    - Contrary to taxpayer favorable court decisions
    - Comment request relating to “minor assembly”
  - Allocation of COGS between DPGR and non-DPGR
  - Computing DPGR from hedging activities

Cases, Guidance & Examination

- *Precision Dose, Inc. v. United States* (Dist. Ct. Ill., 2015)
  - Taxpayer’s activities constituted MPGE rather than packaging, repackaging, labeling, minor assembly
    - Based on *Dean* (gift baskets)
    - See also CCA 201246030 (blister packs)

Cases, Guidance & Examination

- Docketed cases relating to contract manufacturing
  - *Bare Escentuals, Inc. v. Comm'r* (Tax Court)
  - *Hibu Group (USA), Inc. (f/k/a Yellow Book Inc.) v. Commissioner* (Tax Court)
  - *AT&T Advertising, L.P., TP Advertising & Publishing, LLC v. United States* (Court of Federal Claims)

Cases, Guidance & Examination

- Resolved cases related to contract manufacturing
  - *ADVO Inc. v. Comm'r* (Tax Court)
    - Taxpayer lost
  - *Limited Brands, Inc. v. Comm'r* (Tax Court)
    - Taxpayer retained 56% of claimed deduction

Implementation Issues

- Proving benefits and burdens of ownership for contract manufacturing
- Manufactures, produced, grown or extracted
  - Reconsider business activities
- Evolving the computation with the evolution of the group
  - Impacts and opportunities when restructuring

Implementation Issues (contd.)

- Software as the item
  - Third party comparable
  - Software vs. service
- Valuation of non-qualifying services
  - Use of economist to value industry-standard mark-up on embedded services
- Data gathering (synergies with R&D credit)

Guidance Outlook

- Timing of finalization of proposed regulations
- Online software regulations
  - Guidance project on Priority Guidance Plan
  - Comments received

Patent boxes—OECD, EU, & U.S. tax reform

27

- A

- The purposes of a patent box are to encourage—
  - I

2013 BEPS Action Plan Action 5 →

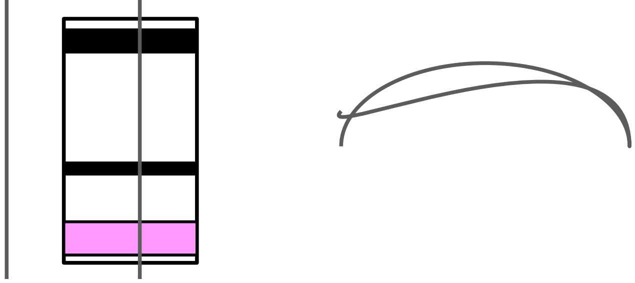
Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime

31

<u>IP-based nexus approach</u> requires tracking IP expenditures, IP assets, & IP income—where such tracking would be unrealistic and require arbitrary judgments, jurisdictions may also choose to allow application of <u>product-based nexus approach</u> so that the nexus can be between expenditures, products (or product families) arising from IP assets, and income:

$$\text{income receiving tax benefits} = \frac{\textit{qualifying expenditures}\text{ incurred to develop }\underline{\text{all IP assets}}\text{ contributing to }\underline{\text{the product}}}{\textit{overall expenditures}\text{ incurred to develop }\underline{\text{all IP assets}}\text{ contributing to }\underline{\text{the product}}} \times \text{overall income from }\underline{\text{the product}}\text{ directly linked to all underlying IP assets}$$

pictorially—



IP assets—patents and other IP assets functionally equivalent to patents, including copyrighted software

nexus ratio—intended to be cumulative with time

nexus ratio—could be treated as rebuttable presumption

qualifying expenditures—incurred by qualifying taxpayer, directly connected to IP asset, <u>including</u> unrelated-party outsourcing but <u>excluding</u> acquisition costs

> blue-sky R&D costs not included in qualifying expenditures of a specific IP asset "to which they have a direct link" could be spread pro rata across IP assets or products; and
>
> jurisdictions may permit a 30% "uplift" to extent taxpayer has nonqualifying expenditures.

overall expenditures—qualifying expenditures + acquisition costs + related party outsourcing

overall income—only includes income derived from IP asset

> services income likely included

EXAMPLES OF PATENT BOXES IN EU COUNTRIES

feature	UK	Ireland
ETR on qualifying profits	10 percent	6¼ percent
qualifying IP	patents, supplementary protection certificates, reg. data protection, & plant variety rights	qualifying computer program or patent from qualifying R&D
qualifying income	net income from qualifying IP	profit from specified trade relevant to qualifying IP
benefit from acquired IP?	yes, if further developed and/or actively managed	partially, if further R&D work done by Irish co. on acquired IP
benefit existing IP?	yes	yes—if Irish co. has incurred qualifying R&D exp. in creating , and holds, qualifying IP
benefit applies to embedded royalties?	yes	yes
can R&D be done abroad?	yes	partially—if R&D done by Irish co. employees in EU and costs don't qualify for deduction there

INNOVATION BOX AS PART OF U.S. TAX REFORM?

EXAMPLE—BOUSTANY-NEAL *INNOVATION PROMOTION ACT OF 2015*—PROP. § 250

feature	description
§ 250(a) deduction	71% × lesser { *innovation box profit* for taxable year, or

...er's U.S. R&D expenditures

× *tentative innovation profit*

innovation box profit

∑ *taxpay...*

allocable deductions

profit

receipts

qualified gross

...ss receipts | gross receipts derived in the ordinary course of taxpayer's U.S. trade or business – certain exceptions | *qualified gr...*

...an, formula, process, design, pattern, or knowhow [§ 936(h)(3)(B)(i)]

...film or videotape [§ 168(f)(3)]

...are [§ 197(e)(3)(B)]

...uced using property described in (A)

qualified property	(A) *patent, inventi...* (B) *motion picture...* (C) *computer softw...* (D) *a product prod...*
qualified services	gross receipts ... from services are excluded from q.g.r.
tax free method of repatriating intangible property	distribution

INNOVATION BOX AS PART OF U.S. TAX REFORM? [CONT'D]

Whether innovation boxes produce benefits (as compared with, e.g., R&E credit) is controversial

Expansion of foreign IP box regimes is perceived as an impetus for U.S. tax reform—part of overall reform that could include:

- innovation box + rules to enable tax-free return of IP
- dividend exemption system with anti-base erosion rules
- transition rules for old foreign-held E&P

IP boxes have (currently) mixed support:

- President's FY2017 budget proposal → no support for IP box
- 2015 Schumer-Portman bipartisan framework for international tax reform → endorsed implementation of an IP box
- House GOP 2016 Blueprint for tax reform → destination-basis approach (boarder adjustments exempting exports from tax, but taxing imports)—move towards an "indirect" tax system
- SFC Chairman Hatch → corporate integration to eliminate double taxation of corporate earnings at corporate & shareholder levels

10-25-16 EC CORPORATE TAX REFORM PROPOSALS

EC set forth three proposals for corporate tax reform, including common consolidated corporate tax base ("***CCCTB***") → two-step implementation:

1st step: Member States agree on a common tax base ("***CCTB***")

a single set of rules is used by all EU MSs to determine taxable profits

e.g., R&D "super-deduction":

100% × R&D costs
+ 50% × (R&D costs not exceeding €20m)
+ 20% × (R&D costs exceeding €20m)

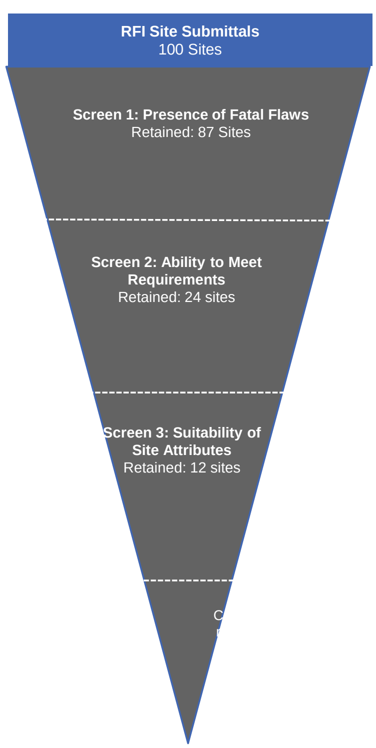
example €100m R&D expenses → deduction:

100% × €100m + 50% × €20m + 20% × €80m = €130m

⇒ IP boxes of each EU country would be irrelevant under CCTB

2nd step: Member States agree on consolidation rules (CCCTB)

tax bases of all members of a consolidate group are added together to give a consolidated tax base → formulary apportionment allocates consolidated tax base to each relevant MS where group has people/assets.


RFI Site Submittals
100 Sites
Screen 1: Presence of Fatal Flaws
Retained: 87 Sites
Screen 2: Ability to Meet Requirements
Retained: 24 sites
Screen 3: Suitability of Site Attributes
Retained: 12 sites

Interaction with US rules

- Foreign tax credit: "soak-up" withholding tax (§§ 1.901-2(a)(3)(ii); 1.903-1(b)(2

Non-Tax Incentives – a Packaged Deal

- Typical incentives:
  - R&D, training and automation grants
  - Duty exemption on imported materials and equipment
  - Land and building subsidies
  - Infrastructure (e.g. dual feed sub stations) assistance
  - Non-financial: foreign labor quota, expedited visas etc.
- Different fiscal implications – writing a check vs. not collecting money

Non-Tax Incentives (cont.)

- Securing business unit buy-in
- Help mitigate initial cash flow and FX risks
- Easier to model, higher NPV
- The magic trade-off ratio