PERSPECTIVE

CHANGES EVERYTHING.

Year-End Tax Update – Policy & Planning

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Tax Topics Today

01 Recent & Pending Legislation

In 2022, provisions of the Tax Cuts and Jobs Act of 2017 began to expire, having a significant impact on the manufacturing sector | Inflation Reduction Act | New legislation

02 IRC 174 Update – New Guidance and Pending Form Change

Absent Congressional action, manufacturers will continue to see increased tax liabilities related to their research expenditures. New guidance compounds the issue and additional information will be necessary for future R&D claims

03 Year-End Tax Planning Opportunities for Consideration

Ways companies can use other provisions of the tax code to mitigate the tax increases between this year and next

Recent & Pending Legislation

Timeline of Scheduled TCJA Changes over the Next Decade

TIMELINE	
After the end of 2021	Businesses will be required to deduct research and experimentation costs over five years, rather than immediately
After the end of 2021	The deduction for business net interest expense will be limited to 30% of EBIT, rather than 30% of EBITDA
After the end of 2022	Full expensing for short-life business investments will begin phasing out
After the end of 2025	The reduction of individual income tax rates will expire
After the end of 2025	The increase in the standard deduction, elimination of the personal exemption, and doubling of the child tax credit will expire
After the end of 2025	Limits on the state and local tax deduction and the mortgage interest deduction will expire
After the end of 2025	The reduction of the alternative minimum tax will expire
After the end of 2025	The newly created pass-through deduction (§199A) will expire
After the end of 2025	Three international-related provisions (GILTI, FDII, and BEAT) will become more restrictive
After the end of 2025	The reduction of the estate tax will expire

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TCJA Changes: Tax Years 2022 & 2023

- IRC 174 – Research Expenditures
  - Capitalization & Amortization
    - Tax years beginning after December 31, 2021
  - Software development expenditures

- Interest Expense Limitation
  - The deduction for net business interest expense will be limited to 30% of EBIT, rather than 30% of EBITDA

- Bonus Depreciation
  - 100% bonus depreciation for short lived assets ended for assets placed in services after December 31, 2022

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New Tax Credits

Inflation Reduction Act (IRA) – IRC 45X

- Advanced Manufacturing Production Credit
  - Specific solar, wind, and battery components
  - Effective January 1, 2023
  - IRS to issue guidance this year

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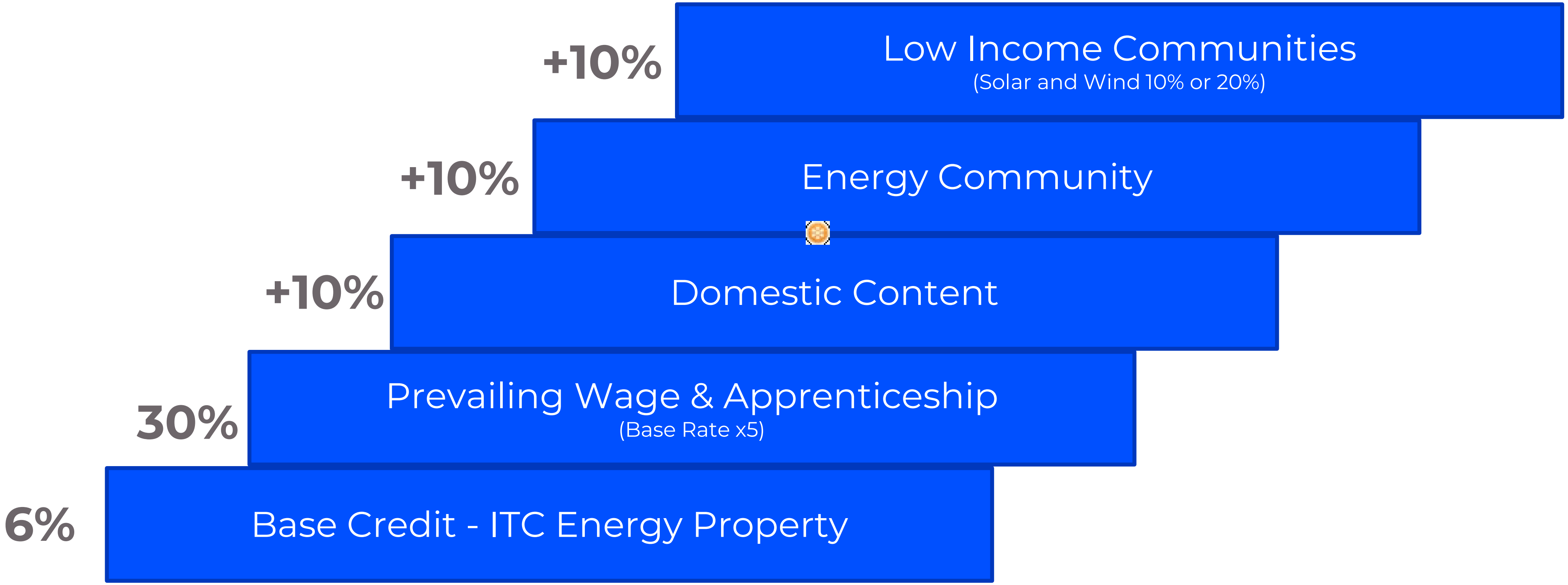
IRA - Renewable/Clean Energy

- Sec. 48 – Investment tax credit
  - Credit for energy property placed into service
  - Typically, we will see this in equipment used to generate solar energy like solar panels and fiber-optic solar
  - In order to take the credit you must meet the following requirements:
    - Original use must begin with the taxpayer
    - Property must be depreciable
    - If the energy property was financed with tax-exempt bonds the credit will be reduced

Enhancement of credits



https://www.whitehouse.gov/cleanenergy/clean-energy-tax-provisions/

Pending Legislation

Pending Legislation

- American Innovation and R&D Competitiveness Act of 2023
  - R&D expensing – Retro-active to 2022
- American Investment in Manufacturing Act
  - Interest expensing – Retro-active to 2022
- Build it in America Act
  - Research expensing, interest expensing, 100% bonus
  - Retro-active to 2022

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02

IRC 174 & IRC 41

New Guidance on IRC 174 Research Expenditures

New R&D Tax Credit Form Forthcoming

Major Change: Research Expenditures

- Change made by the TCJA
- Effective for tax years beginning after December 31, 2021
- Requires capitalization of research expenditures, with amortization period of 5- or 15-year period
- Software development is research

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IRC 174: Details & Mechanics

- Amortization period – 5 vs. 15 years
- Midpoint amortization convention
- Disposition / abandonment, continue or lose
- Required statement in lieu of current year Form 3115 – Application for Change in Accounting Method

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IRC 174: Details & Mechanics

- IRC 174 (expense) broader than IRC 41 (tax credit)
    - All costs incident to the development of a product…
- R&D tax <u>credit</u> claim is irrelevant – IRC 174 applies regardless of R&D tax credit claim
- Potential state conformity implications

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Example #1: Midpoint Convention

IRC 174 Research Expenditures: $1,000,000

Tax Year	Amortization Amount	Percent Recovered
2022	$100,000	10%
2023	$200,000	20%
2024	$200,000	20%
2025	$200,000	20%
2026	$200,000	20%
2027	$100,000	10%
Total	$1,000,000	100%

Example #2 – ABC Processing

Plastics Processor:	Sales | $22,000,000
R&D claimed 2019-2021:	$400,000
2022 Research Expense:	$2,300,000
2022 R&D tax credit:	$130,000
2022 Amortization Expense:	$230,000
Additional taxable income:	$2,070,000
Additional federal tax, 2022:	> $610,000
Additional federal tax, net of R&D credit:	> $480,000

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* Marginal tax rate used: 29.6%

Example #3 – XYZ Molding & Tooling

Processor & Tool Shop:	Sales | $14,000,000
R&D claimed 2019-2021:	$0
2022 Research Expense:	$1,100,000
2022 R&D tax credit:	$0
2022 Amortization Expense:	$110,000
Additional taxable income:	$990,000
Additional federal tax, 2022*:	> $290,000
Additional federal tax, net of R&D credit:	> $290,000

* Marginal tax rate used: 29.6%

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New Guidance

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Notice 2023-63 Summary

- This is interim guidance; IRS intends to issue Proposed Regulations.
- Applicable for tax years ending **AFTER** Sept 8, 2023
- Capitalization/Amortization of Section 174 (SRE) costs
    - Non-exhaustive list of types of costs, examples, and allocation methods
    - Distinction for software development costs
    - Distinction for costs under contract
- Distinction for disposition
- Treatment under S460 (long term contracts / % of completion)
- Treatment under S482 – cost sharing arrangements

Types of SRE expenditures

- Labor
  - All elements of compensation; does NOT include severance payments
- Materials/Supplies
- Recovery allowances
  - Depreciation, amortization, depletion allowances
- Patent
- Operation and Mgmt Costs
  - Rent, utilities, insurance, taxes, repairs and maint, security costs, similar overhead
- Travel

Types of cost (NOT SRE)

- General and Admin Serv Depts that ONLY indirectly support or benefit S174 activities (payroll, HR, accounting, etc)
- Interest on debt to finance SRE activities
- Section 5.05 – Activities that are NOT treated as software development – separate slide
- Costs related to
  - Input content into a website
  - Website hosting, periodic fee to Internet provider
  - Registration costs for Internet domain

Types of cost (NOT SRE) (continued)

- Treas Reg 1.174-2(a)(6)(i-vii) Exclusions
  - Ordinary testing and inspection – quality control
  - Efficiency surveys
  - Management studies
  - Consumer surveys
  - Advertising or promotions
  - Acquisition or another’s patent, model, production or process
  - Research in connection with literary, historical, or similar projects
- Amortization of SRE (related to any Tax Year)

Key Take Aways

Consistency requirement

- If it's an SRE expenditure it <u>may NOT be treated as</u>
  - S162 – general business expense
  - S195 – Intangibles
  - S263a – Capital expenditures where no deduction is allowed
  - S263A – UNICAP
  - S471 – Inventory

Disposition

- In year incurred, if expenditures are disposed of prior to midpoint – still amortizable.
- Corporation ceases to exist.
  - **Under S381(a)** – acquiring corporation will continue amortization of unamortized S174
  - **NOT in S381(a)** – the corporation IS allowed a deduction equal to the unamortized S174 in it's final taxable year.

    - <u>Does NOT apply if </u>principal purpose of the transaction is to claim a deduction for unamortized S174. (anti-abuse)

2023 Approach

- SRE costs will include
  - Specifically identified SRE cost
  - Estimated SRE cost
- Estimated SRE cost
  - Trial balance review
  - Establish allocation method(s)

- **For any remaining 2023 estimates**
  - pass-through entities and eligible corporations, reconsider safe-harbor amount (CY > PY)
  - Large corporations – 2023 Section 174 amount to be increased versus 2022 Section 174 amount – consider annualization.

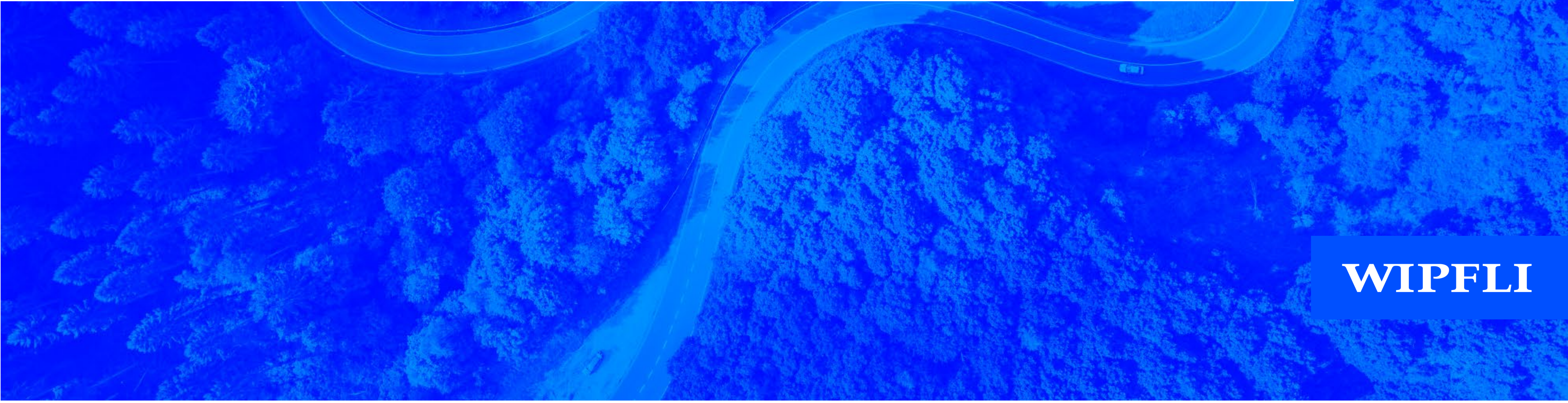
Allocation Method Examples

- Labor costs examples
  - Total Q headcount / Total headcount
  - Total Q hrs / Total PAID (all employees)
  - Total labor QREs / Total GL wage accounts

- Building costs examples
  - Total Q hrs / Total Hrs WORKED (all employees)
  - % of working days in the office vs at home (all employees)
  - SF of building use (dev vs other)
  - Industry WILL matter!!
    - Trial runs vs commercial production

R&D Tax Credit

New Reporting Requirements Forthcoming



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AUDIT ENVIRONMENT

- R&D specialty group focuses on R&D credit audits
- Appeals backlog at 12 – 24 months
- IRS hiring additional employees
- Key audit focus points
- Amended R&D credit claims – additional substantiation documentation required

R&D CREDIT REFUND CLAIMS / AMENDED RETURNS

- Chief Counsel Memorandum (FFA 20214101F)

  For taxpayer's refund claim for Sec 41 RD credit to be valid, the taxpayer must, at a minimum:

  - Identify all the business components to which the Sec 41 R&D claim relates

  - For each business component:
    - Identify all research activities performed
    - Identify all individuals who performed each research activity; and
    - Identify all the information each individual sought to discover.

  - Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year (this may be done using Form 6765)

  - A taxpayer must provide a declaration signed under the penalties of perjury verifying that the facts provided are accurate. (In most cases, the signature on Forms 1040X or 1120X serves this function.)

  - Grace Period – extended to 45 days

  - Transition Period – extended to 1/10/2024

FORM 6765 CHANGES

- IRS is considering Form 6765 changes
- Potentially 2023 or 2024 return
- Builds upon CCM requirements
- Data being considered at this point
  - List of entities with QREs and business activity code
  - QREs by business component
  - Brief description of qualified research performed
  - Statement if taxpayer is following the ASC 730 directive
  - Statement regarding whether the credit includes any new categories of activities
  - List of any acquisition or dispositions in the tax year
  - Total number of business components
  - Total amount of wages on Form 1125-E that are included in QREs
  - Statement regrading whether the taxpayer is a member of a controlled group and identifying other members that contribute to the group credit

03

Year-End Tax Plannning

Tax Credits & Incentives for Manufacturers

R&D Tax Credit

- Development or improvement of business components (products and processes)
- Proprietary and custom development qualifies

Accounting Methods

- Cash Basis | UNICAP | Inventory
- Last-In-First-Out (LIFO)

State and Local Tax

- Sales tax exemptions
- Entity Level Tax elections (SALT CAP workaround)

Hiring & Payroll Incentives

- Work Opportunity Tax Credits (WOTC)
- Employee Retention Credit (ERC)

Plant & Equipment

- Cost segregation study
- Energy Efficient Building Deduction

Other Planning

- Bonus depreciation
- IC-DISC

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QUESTIONS

Appendix

Research & Development Tax Credits

Qualified Research Activities

New or improved business component

- Development of a new or improved business component
  - Includes: Product, Process, Technique, Formula, Invention, or Computer Software

Technological in nature

- Relies on the principles of the hard sciences (physics, chemistry, biology, engineering, or computer science, etc.)

Deductible under Sec. 174 (eliminate uncertainty)

- Capability – Can we do it?
- Methodology – How do we do it?
- Appropriate Design – What is the best design to meet our objectives?

Process of experimentation

- Formal or informal, evaluation of alternatives, systematic trial and error

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Examples of Qualified Activities

- Developing new, part-specific manufacturing processes
- Designing, developing and sampling new partsg
- Design for manufacturability changes and validation
- Designing and developing new fixturing or jigs to make prototypes or first article parts
- Experimenting with performance variables to improve manufacturing processes
  - OEE and/or scrap reduction
- Improving processes through robotics or other types of automation techniques
- Experimenting with new resins or other materials
- Sampling / Experimenting / Qualification of new parts or processes

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Qualified Expenditures and Credit Amount

- Qualified wages
  - Direct research
  - Direct supervision
  - Direct support
- Contract research expenses
- Supplies
- Computer lease time

- Federal credit amount
  - Traditional – 20%
  - Simplified – 14%
- State credit amounts
  - Research performed in the state
  - Federal definition
  - Ranges – 1% to 24%

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OPPORTUNITIES / OBSERVATIONS

- New/improved manufacturing tools (design/build vs buy)
- Automation of manual or semi-auto processes (design/build vs buy)
- Continuous improvement / lean manufacturing
- Development in response to supply chain issues
- Direct support and direct supervision roles
- Cloud-based software development environments
- Customer portal development
- Pilot model rules
- Self-constructed assets

Accounting Methods

Accounting Methods

- Tax Cuts & Jobs Act Opportunities
  - Cash Basis
  - UNICAP | Inventory
  - Requirements
    - Average Annual Gross Receipts - $27 million
    - No tax shelters
- Increasing Cost of Raw Materials
  - LIFO Method of Accounting

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Hiring & Payroll Incentives

Work Opportunity Tax Credit

- Up to $9,600 Federal tax credit for each eligible to hire
- Percentage of eligible employee wages (must work 120 hours)
- May not double dip with the Employee Retention Credit
- Targeted Groups
  - Eligible veterans
  - SNAP (food stamp) recipients
  - TANF recipients
  - Qualified long-term unemployment recipients
  - Designated community residents
  - Vocational rehabilitation referrals
  - Ex-felons
  - SSI recipients
  - Summer youth

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Employee Retention Credit

Who Can Qualify:

- Fully or partially suspended to due covid-related government orders
- Decline in quarterly gross receipts, compared to same quarter in 2019:
  - Q2 to Q4 2020 50% decline in gross receipts when compared to 2019
  - Q1 to Q3 2021 20% decline in gross receipts when compared to 2019

- Large employers: Paid employees who were not performing services
  - Including health insurance counts
  - Includes large employers (>500 employees)

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Employee Retention Credit

Amount of the Credit:

- 2020: 50% of first $10,000 per employee
  - $5,000 ***per employee*** for the year
- 2021: 70% of first $10,000 per employee per quarter
  - $21,000 ***per employee*** for the year if all three quarters qualify

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Employee Retention Credit

Additional commentary:

- Method of accounting
- ESOPs can qualify
- Companies with NOLs can benefit
- 5-year statute of limitations
- Refunds are taxable

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Employee Retention Credit

AICPA Fact or Fiction

My business did not have a significant revenue decline in a calendar quarter compared to 2019 (50% or more for 2020 or 20% or more for 2021), but I can still qualify for an ERC.

FACT. However, as noted above, there must have been a full or partial suspension of operations BECAUSE OF A GOVERNMENT ORDER that limited commerce, travel or group meetings due to COVID-19. A partial suspension is based on the facts and circumstances of what government orders are in place for the location. The orders would need to have a more than a nominal impact on the business to qualify for the ERC.

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Employee Retention Credit

AICPA Fact or Fiction

All safety recommendations or guidelines a government agency issues should be considered government orders to suspend operation requirements.

FICTION. Government orders are defined as orders, proclamations and decrees from federal, state or local governments that have jurisdiction over the business operations. No federal order during 2020 or 2021 would qualify businesses for the ERC, so it is important to review the state and local orders.

Employee Retention Credit

AICPA Fact or Fiction

My business experienced supply chain disruption, which means it qualifies for the ERC.

FICTION. Experiencing supply chain issues stemming from the pandemic does not guarantee ERC eligibility. The supply chain issues must result from a government order that affects its supplier, and **ALL** these requirements must be met:

- Supplier cannot make deliveries of critical goods due to a government order.
- Business can't purchase those critical goods from another supplier.
- Business must experience a more than nominal effect as a result.

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Employee Retention Credit

AICPA Fact or Fiction

My business was in a location where there was a stay-at-home order, and I adjusted operations based on this. This automatically means I can claim the ERC.

FICTION. The IRS clearly states that voluntary reductions of hours or closing based on service demand do not create a full or partial suspension of its operations due to a government order.

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Employee Retention Credit

AICPA Fact or Fiction

There were so many claims for the ERC that the IRS is unlikely to audit my business' return.

FICTION. While there is no guarantee that the IRS will examine your business' ERC claim, they are aware of the potential for abuse related to this credit and scrutiny of COVID-19 relief funds are high in general.

If my business must pay back the ERC, the penalties will be large.

FACT. The amount of the penalty (and interest) on the unpaid payroll taxes could be substantial, especially if the IRS imposes fraud and negligence penalties upon examination.

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Plant & Equipment

Manufacturing Plant & Equipment

- Cost Segregation Study
  - Bonus depreciation and the definition of Qualified Improvement Property made this extremely powerful
  - Repairs & Maintenance

- Energy Efficient Building Deduction
  - Lighting, HVAC or Building Envelope
  - As much as $5.00 per square foot

- Self-Constructed Assets
  - Process Research & Development
  - Design & Development of equipment & processes – IRC 174(a)

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