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Tried & True Tax Strategies Still Ticking

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Presented by
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About the speakers

Bruce Stubbs, JD, LLM
Vice President
AGH Specialized Tax Solutions

20 years of legal/tax consulting experience

Specialized knowledge in R&D tax credits, cost segregation and the repair regulations

About the speakers

John Trowbridge
Senior Vice President
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30 years of tax consulting experience

Handles client relationships and development

Member of AICPA, KSCPA and RMA

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Learning objectives

Identify the business circumstances that can allow the implementation of new tax strategies

Learn how R&D tax credits, cost segregation, and IC-DISC can benefit your business

Understand updates to the TCJA Act for bonus depreciation and Section 179 expensing

Introduction to Qualified Opportunity Zones/Funds

R&D TAX CREDIT

Federal credit benefit

- Averages 7.9¢ per dollar on qualified R&D
- General business credit
- Dollar-for-dollar reduction in tax
  - May be subject to Alternative Minimum Tax (AMT) limitations
- 1-year carryback, 20-year carryforward

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PATH Act of 2015

- **PERMANENT**
- No changes to credit percentage rates or methods
  - Regular Credit – 20%
  - Alternative Simplified Credit – 14%
- New options for some to utilize the credit:
  - Offset against AMT
  - Offset against payroll tax

PATH Act of 2015 (cont.)

- Ability to offset AMT allowed
- Applies to:
  - Tax years beginning **after** Dec. 31, 2015
- Limited to:
  - "**Eligible** small businesses" (ESB) – defined as:
    1. Corporation – the stock of which is not publically traded,
    2. Partnership, or
    3. Sole proprietorship, and
    4. Prior 3-year average annual gross receipts do not exceed $50 million

PATH Act of 2015 (cont.)

- Ability to utilize the credit to offset payroll taxes
- Applies to:
  - Startup companies
  - Tax years beginning **after** Dec. 31, 2015
- Limited to:
  - "**Qualified** small businesses" (QSB) – defined as:
    1. Corporation, partnership, or individual,
    2. Gross receipts < $5 million, and
    3. No gross receipts for any tax year preceding the 5th tax year period ending with the current tax year

PATH Act of 2015 (cont.)

Payroll tax credit is equal to the **least of**:

1) amount specified by the taxpayer $\leq$ \$250,000,
2) research credit determined for the tax year, or
3) if a QSB *other than* a partnership or S corp., the amount of the business credit carryforward under §39 from the tax year.

PATH Act of 2015 (cont.)

Payroll tax credit limitations:

1. Payroll tax credit allowed against employer OASDI (social security 6.2%) portion of FICA in 1st quarter *after* date on which company files its income tax or information return
2. Can't exceed OASDI each quarter, carryforward to next quarter
3. Can't be taken against employer HI (hospital insurance 1.45%) portion of FICA taxes
4. Can't be taken against the employee OASDI liability required to be withheld

Tax Cut and Jobs Act (TCJA) of 2017

- **TCJA of 2017 provided**
  - 14% increase in value
    - Top corporate tax rate reduction from 35% to 21%
    - 280C Reduced Credit Election changed from 65% to 79%

	65%		79%	
Taxable Income		**550,000**		**550,000**
Tax @ 37%		203,500		203,500
R&D Credit				
Gross Credit	**75,000**		**75,000**	
Reduced Credit	48,750	48,750	59,250	59,250
Tax Liability		**154,750**		**144,250**

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TCJA of 2017 (cont.)

CHANGE IS COMING

- Tax years beginning after Dec. 31, 2021
- R&D expenses must be capitalized & amortized ratably over
  - 5 years for U.S. R&D expenses
  - 15 years if conducted outside the U.S.

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Credit qualification myths

- Must "*discover*" something beyond what is known in the industry
  - **False** – "Discovery Test" is no longer the standard.
- Only performing "white lab coat" type activities in a high-tech or bio-tech company qualifies.
  - **False** – Anyone who satisfies the 4-Part Test can qualify.
- Must be successful and product must be available for sale.
  - **False** – Neither are required to qualify for the credit.
- Government contractors don't qualify.
  - **False** – Anyone who satisfies the 4-Part Test can potentially qualify.
    - Need to be "at risk" and "retain rights"
    - Contract terms are key

Applicable industries

Applies to all industries, including:

- Aircraft
- Agriculture
- Apparel
- Automotive
- Chemical
- Computer software
- Cosmetics
- Defense contractors
- Electronics
- Engineering
- Equipment & machinery
- Food & beverage
- Manufacturing
- Medical
- Oil & gas
- Pharmaceutical
- Telecommunications
- Tooling, molds & dies

Study examples

- Packaging films – 3D and holographic
- Bee Shotgun – Developed a ‘gun’ to launch a shell filled with non-lethal smoke to disperse bees on power poles
- Pet products – Puppy pads, soaps, odor removers (chemical formulas)
- Formulas – Food & beverage service providers, flavor formulations, new & replacement ingredient selection, organic and natural foods
- Electric fans – Residential and industrial – motors, blade & case designs
- Defense contractor – Switch components & wiring harnesses for weapons
- Original equipment manufacturers (OEMs):
  - Cable assemblies & throttle controls – Motorcycles and riding lawn mowers
  - Plastic tubing – Medical devices & equipment

R&D 4-Part Test

Test # 1 **Elimination of uncertainty**	• Must be present at beginning of project • Uncertainty concerns: capability, methodology or appropriateness of design
Test # 2 **Technological in nature**	• Physical or biological sciences, computer science or engineering
Test # 3 **Permitted purpose**	• New or improved *business component* as to: function, performance, reliability or quality • Not qualified if relates to: style, taste, cosmetic or seasonal design factors
Test # 4 **Process of experimentation**	• Evaluate one or more alternatives to resolve uncertainty. • Substantially all activities ($\geq$ 80%) constitute elements of a process of experimentation.

Qualified R&D Expenses

Three buckets of costs can qualify:

1. Wages
2. Supplies
3. Contract Research

Qualified activities

Idea generation:

- Concept design
- Technical / performance specifications identified
- Technical team meetings

Prototype design:

- 3D modeling
- Technical design meetings
- Production capability assessment
- New tooling design & development

Prototypes:

- CAD analysis
- Product mock-up
- Destructive or non-destructive testing
- QA testing
- Life cycle testing
- Field testing

Final approvals:

- Design
- Performance specs
- Safety review
- Certifications

POLLING QUESTION #1

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Tax Cuts and Jobs Act (TCJA)

TCJA: Changes to Sec. 179 expensing

Prior law:

- $500,000 maximum expense
- $2,000,000 investment phase-out
- Expensing of Qualified Real Property

TCJA: Changes to Sec. 179 expensing

TCJA changes

- Effective for acquisition after 9/27/18
- $1,000,000 maximum expense and $2,500,000 investment phase-out
- Eliminated exclusion of personal property connected to residential rental property
- Qualified Improvement Property
  - Included improvements to an interior portion of non-residential real property
  - Subject to certain limitations

TCJA: Changes to bonus depreciation

- 50% bonus depreciation temporarily increased to 100% (9/27/17 - 12/31/22)
- Now includes used property
- Technically excludes Qualified Improvement Property
- Luxury auto limits increased substantially

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POLLING QUESTION #2

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Cost segregation

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Cost segregation defined

- Formal engineering process accepted by the IRS
- Identifies building costs and land improvement costs traditionally depreciated over 39 years for Nonresidential Real Property or 27.5 years for Residential Rental Property
- Re-allocates a significant amount of the “building” costs to asset classes with shorter depreciation lives (accelerated depreciation)
- Qualifying costs are assigned to 5, 7 and 15 year lives
- Results in:
  - Accelerated depreciation deductions
  - Reduced tax liability
  - Increase in cash flow

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Benefits of cost segregation

- Cost segregation studies **accelerate** deductions, **reduce** current tax liability & **increase** cash flow.
- Studies **do not increase** overall depreciation deductions.
- Total capitalized costs for a building & land improvements will fully depreciate **with or without** a study performed.
- Benefit: **Time Value of Money**
  - *"A dollar today is worth more than a dollar tomorrow."*

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When to perform a study

Most properties will benefit:

- New construction
- Acquisitions
- Existing properties – “look-back” and “catch-up”
- Leasehold improvements
- Remodel
- Green / LEED projects

Study is not recommended if:

- Owner plans on selling the property within the first 3-5 years of ownership because of depreciation recapture.

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Property reclass percentages

PROPERTY TYPE	TYPICAL RECLASS %
Assisted Living / Ambulatory Facility	15 - 25%
Apartment / Multi-Family Building	15 - 30%
Automobile Dealership	20 - 35%
Bank Buildings	25 - 35%
Computer Data Center / Technology Center	20 - 45%
Distribution	5 - 15%
Fitness Center / Health Club	20 - 45%
Golf Course	20 - 40%
Grocery Stores	20 - 30%
Healthcare / (Medical / Dentist / Diagnostic)	30 - 40%
Hospitality / Hotels	20 - 35%
Industrial / Manufacturing	30 - 45%
Office Building	15 - 30%
Printing Facility	15 - 35%
Research and Development	20 - 50%
Restaurants (Single or Multiple)	20 - 38%
Retail (Department / Specialty Store)	20 - 30%
Self Storage Facility	20 - 45%
Shopping Center	15 - 30%
Theater	20 - 35%
Warehouse	10 - 15%

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Example: Hotel

Type: New construction – current year study

Cost: $4,505,035

Placed in service: 2014

% Reclassified: 30.5%

1st year additional depreciation **$797,530**	1st Year Tax Savings Benefit $315,822
1st five years additional depreciation **$1,128,571**	1st five Years NPV Tax Savings Benefit $437,760
Overall NPV Tax Savings **(Net Present Value)**	$243,002

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Example: Car Dealership

Type: Renovation / remodel of showroom – current year study

Cost: $2,237,000

Placed in service: 2013

Study performed: 2013

% Reclassified: 23.8%

1st year additional depreciation $311,472	1st year NPV tax savings benefit $123,031
1st five years additional depreciation $447,208	1st five years NPV tax savings benefit $170,414
Overall NPV tax savings (net present value)	$123,787

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Acquisition benefits – post TCJA

Apartment Complex
Purchase price $5,476,000
Reclassified: 24.64%
Tax rate (combined): 26.7%

	Pre – 9/27/2017	TCJA benefits
Bonus amount	0%	100%
1st year additional depreciation	$152,753	$1,322,705
1st year additional tax savings	$ 40,785	$ 353,162
1st five years additional depreciation	$710,139	$1,322,705
1st five years additional tax savings	$171,212	$ 308,793
Overall NPV tax savings	$119,895	$ 196,225

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Increased importance

Eight building systems specifically identified by the "repair regs":

1. HVAC systems
2. Plumbing systems
3. Electrical systems
4. All escalators
5. All elevators
6. Fire protection and alarm systems
7. Security systems
8. Gas distribution system
9. *Other structural components identified in published guidance in the Federal Register or in the Internal Revenue Bulletin*

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POLLING QUESTION #3

IC-DISC

IC-DISC: What is it?

IC-DISC =

Interest Charge Domestic International Sales Corporation

IC-DISC: What is it?

IC-DISC is an IRS-approved tax strategy that can provide cash to exporters and their owners through tax savings.

"The last remaining export incentive…"

- Ryan L. Losi

Key elements

- Open to domestic exporters who meet criteria
- Relatively easy to create/administer
- “Paper corporation”
- Tax exempt
- Dividends qualify for reduced tax rate

Foreign Trading Gross Receipts (FTGR)

Qualified export receipts that include:

- **Export property**
- Supporting services
- Interest on **qualified export assets**
- Non-US engineering / architectural services

Export property

- U.S. grown, produced or manufactured
- Mainly for sale outside US
- **More than** 50% of FMV attributed to US content

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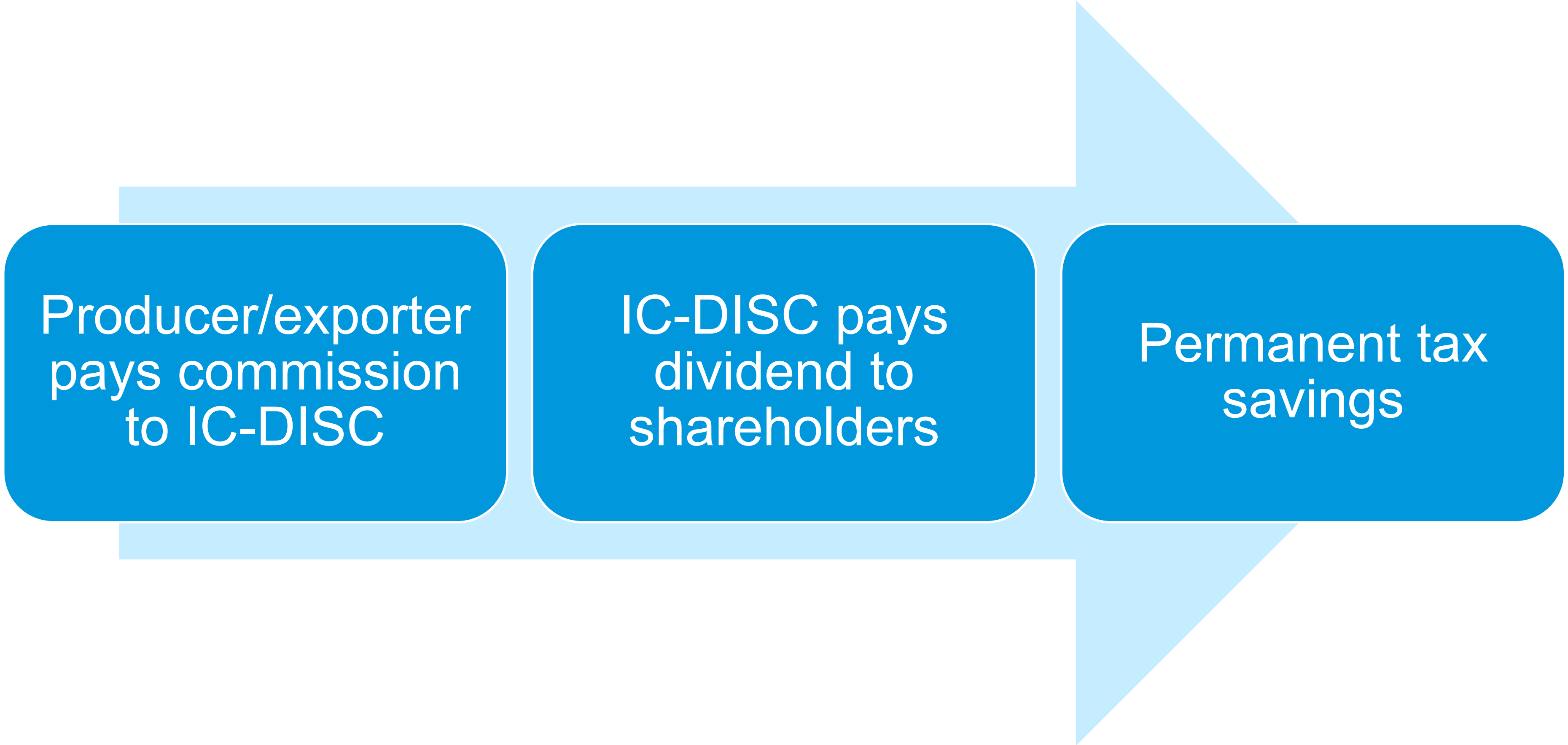
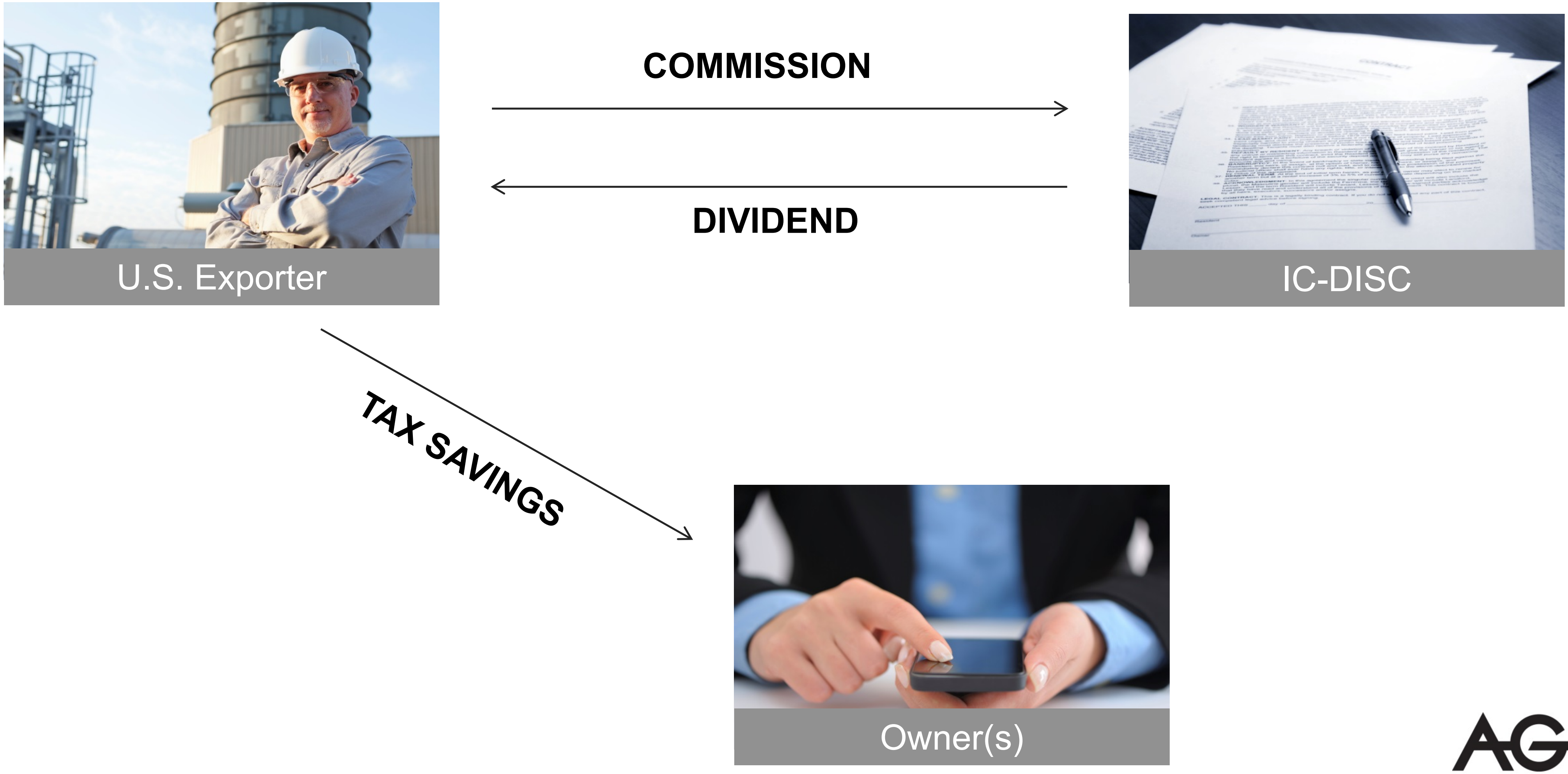
Qualified export assets

- At least 95% of DISC assets at year-end must be qualified export assets:
  - Trade receivables
  - Temporary investments
  - **<u>Producer loans</u>**

Potential tax savings



Typical structure – S corporation / partnership



Typical structure – C corporation

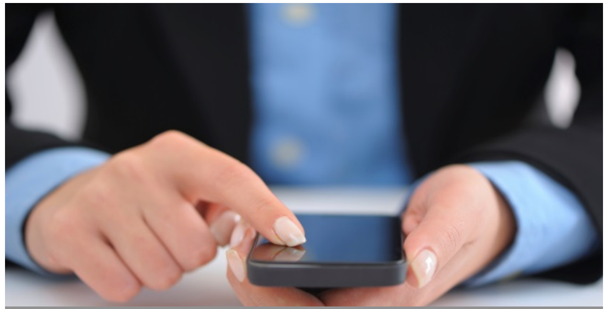
U.S. Exporter

COMMISSION

TAX SAVINGS

IC-DISC

DIVIDEND



Owner(s)

Tax savings example

Foreign trading gross receipts	$4,000,000
Cost of goods sold	$2,500,000
Gross margin	$1,500,000
Allocable operating / G&A expenses	$ 500,000
Export sales net income	**$1,000,000**
IC-DISC commission is greater of:	
50% of export net income	$ 500,000
4% of export receipts	$ 160,000

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Tax savings example (cont.)

IC-DISC commission	$500,000
Federal tax savings at 29.6%	$148,000
IC-DISC dividend distribution	$500,000
Federal tax cost at 23.8%	(119,000)
Net tax saving (pass-thru)	**$ 29,000**
Net tax savings (C-corp)	**$105,000**

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Tax deferral / producer loan

- IC-DISC commission functions like a loan
- Producer deducts interest paid to DISC
- Tax deferral “cap”
- Shareholder pays “interest charge” to IRS

Maintenance steps

1. Maintain separate books & records
2. Timely commission calculation & maximization
3. Timely fund movement
4. Producer loan documentation, if applicable
5. Tax preparation

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Costs

One-time implementation costs:
- **$6,000 - $10,000**

Annual maintenance costs:
- **$4,000 - $8,000**

***IMPORTANT – Benefits only for shipments after formation**

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POLLING QUESTION #4

Qualified Opportunity Zones (QOZ)

Deferral and possible reduction of capital gains

- Any capital gain after 12/31/17
- Invest gain in QOZ, designated by each state
- Defer up to 10 years
- 10% CG Tax haircut after five years, 5% more after seven years
- **No tax** on second gain if left in QOZ for 10 years

Thank you for attending

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