

A Global Review of Tax Incentives

High Tech Tax Institute
November 8, 2016

- **Kevin Dangers**—partner, EY
- **Rod Donnelly**—partner, Morgan Lewis
- **Steven Shee**—VP, Global Tax & Government Relations, *Sandisk*

Research Credit and § 199

Recent Research Credit Case Decisions / Guidance

- ▶ *Suder v. Comm’r* (Tax Ct. 2014)
 - ▶ Roadmap for successfully substantiating QREs
- ▶ *Geosyntec Consultants, Inc. v. United States* (11th Cir. 2015)
 - ▶ Fixed-price contracts not “funded” research
- ▶ *Trinity Industries, Inc. v. United States* (5th Cir. 2014)
 - ▶ Methodology for current year must be consistent with base years
- ▶ *Bayer Corporation v. United States* (W.D. Pa. pending)
 - ▶ Statistical sampling; trial on 10 sample claims in January 2016
- ▶ Proposed 174 Regulations – responding to *TG Missouri* (Tax Ct. 2009)
- ▶ Internal Use Software Regulations

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 beginning before October 4, 2016

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)

- ▶ The final regulations exclude the following from the application of the IUS rules:
 - ▶ Computer software and hardware developed as a single product (or to the costs to modify an acquired computer software and hardware package), of which the software is an integral part, that is used directly by the taxpayer in providing services in its trade or business is not treated as IUS.
 - ▶ Software developed for use in an activity that constitutes qualified research (other than the development of the internal-use software itself) does not have to satisfy the IUS rules.
 - ▶ Software developed for use in a production process to which the requirements of section 41(d)(1) are met does not have to satisfy the IUS rules.

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)

- ▶ High threshold of innovation test – applicable only to IUS
- ▶ Innovativeness test
 - ▶ Adopts concepts from 1986 legislative history
 - ▶ Software is innovative if there is a reduction in cost, improvement in speed, or other measurable improvement that is substantial and economically significant

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 be purchased, leased or licensed and used for the intended purpose without modifications that would satisfy the other tests

Final Regulations (cont'd)

- ▶ Common questions:
 - ▶ If only the taxpayer’s employees use the software, is it “internal-use software”?
 - ▶ Is third party interaction required to be considered non-internal-use software?
 - ▶ If data is mined from the software used by the taxpayer’s customers/clients, will it be considered “dual function software”?
 - ▶ If the taxpayer develops software to be used by its customer for a G&A function, is that internal-use software?

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
 - ▶ Is it used to deliver a core business service?
 - ▶ Does the software benefit only the taxpayer?

§ 199 Agenda

- ▶ Statutory changes
- ▶ Proposed regulations
- ▶ Recent cases, guidance, examination
- ▶ Implementation issues
- ▶ Guidance outlook

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

- ▶ Chief Counsel Advice (CCA) 201545018 and CCA 201630015
 - ▶ Contract film production by sports league team
 - ▶ Based on *ADVO* (publisher/printer)
- ▶ TAM 201638022
 - ▶ Under construction activity rules, constructed property is within the definition of real property and is not equipment
 - ▶ Analysis under § 263A
- ▶ CCA 201642033
 - ▶ Loss on the sale of equipment used in production of QPP not allocable to DPGR

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

Cases, Guidance & Examination

- ▶ Examination activity
 - ▶ IPG (Issue Practice Group)
 - ▶ Increasing interest in software claims
 - ▶ § 199 “campaign”?

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
- ▶ Outlook for IRS administrative guidance

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

27

PATENT/INNOVATION BOXES—BACKGROUND

- A patent box is a set of tax laws giving a lower tax rate—generally from 5%–15%—of tax on income from patents.
- Some countries’ laws give a lower rate of tax on income from non-patented & patented IP → innovation box.
 - ◊ e.g., Hungary, Lux, & Spain incl. designs, copyrights, & models.
- Unlike “front-end” incentives (§§ 174 & 41) for R&D, patent boxes are a “back-end” incentive—taxpayers only benefit if they have income from IP.
- The benefit patent boxes give generally increases as more R&D expense is incurred in-country.
- Patent box benefits can apply to categories of income—
 - ◊ narrowly—e.g., only on royalties from licensing patents; or
 - ◊ broadly—more types of income attributable to IP.

28

PATENT/INNOVATION BOXES—BACKGROUND [CONT'D]

- The purposes of a patent box are to encourage—
 - ◊ location of profits from IP in-country; and
 - ◊ location of R&D in-country.
- Whether patent boxes make policy sense, or are better than alternative structures, is the subject of debate. A factor is whether the benefit is applied to—
 - ◊ net profit (lower tax rate applies to deductions)
 - ◊ gross profit (deductions still valued at regular statutory rate)
- Patent boxes have been proliferating in EU countries, and more recently in Asia—e.g., China, and India.
- OECD BEPS Action 5 gave minimum standards for preferential tax regimes (including IP boxes) to avoid being “harmful” → countries made changes to address
- Some U.S. tax reform proposals endorse patent boxes.
- Recent EC tax proposals would obviate patent boxes. **29**

BEPS ACTION 5—HARMFUL PREFERENTIAL TAX REGIMES

Framework under 1998 OECD Harmful Tax Competition Report for determining harmful preferential regimes.

1st—is regime within the scope of the FHTP and preferential?

◊ regime must:

- relate to business taxation of relevant income from geographically mobile activities (e.g., financial & provision of intangibles); and
- be preferential in comparison with general taxation principles.

2nd—is preferential regime potentially harmful?

◊ low or zero effective taxation + one or more of remaining factors
⇒ regime is potentially harmful

3rd—is potentially harmful regime actually harmful?

◊ regime must have created “harmful economic effects”

If a preferential regime is actually harmful ⇒ other countries may take defensive measures to counter the effects of the harmful regime.

ACTION 5—SUBSTANTIAL ACTIVITY REQUIREMENT

◇ 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. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

◇ 2014 BEPS Action 5 Report *Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance* →

- “substantial activity” factor + four key factors will be used to determine whether preferential regime is potentially harmful;
- **Substantial activity requirement in context of intangible regimes**—IP-intensive industries are a key driver of growth and employment; countries are free to provide tax incentives for R&D activities provided they’re granted according to principles agreed by FHTP.

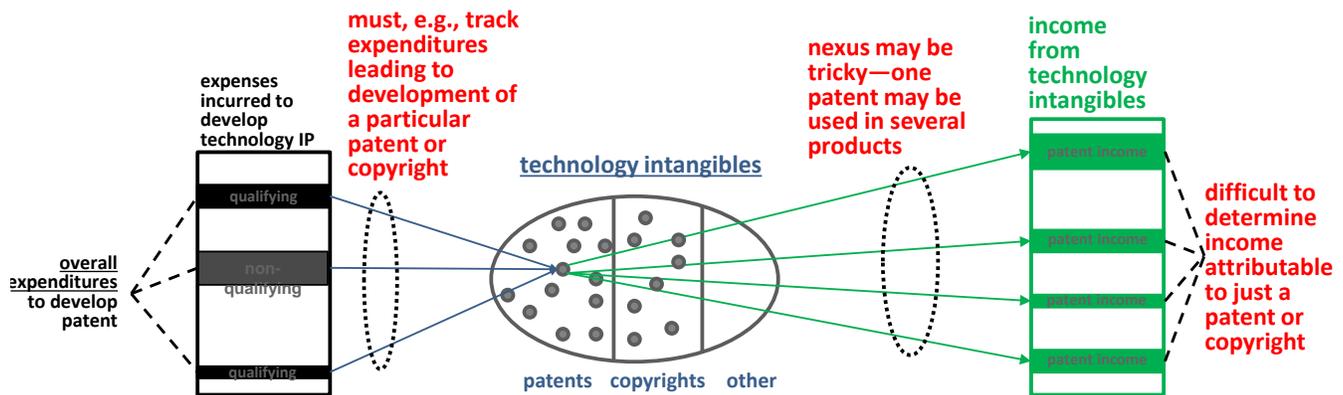
31

ACTION 5—SUBSTANTIAL ACTIVITY REQUIREMENT [CONT'D]

OECD adopts modified IP-based nexus approach—

$$\text{income receiving tax benefits} = \frac{\text{qualifying expenditures incurred to develop IP asset}}{\text{overall expenditures incurred to develop IP asset}} \times \text{overall income from IP asset}$$

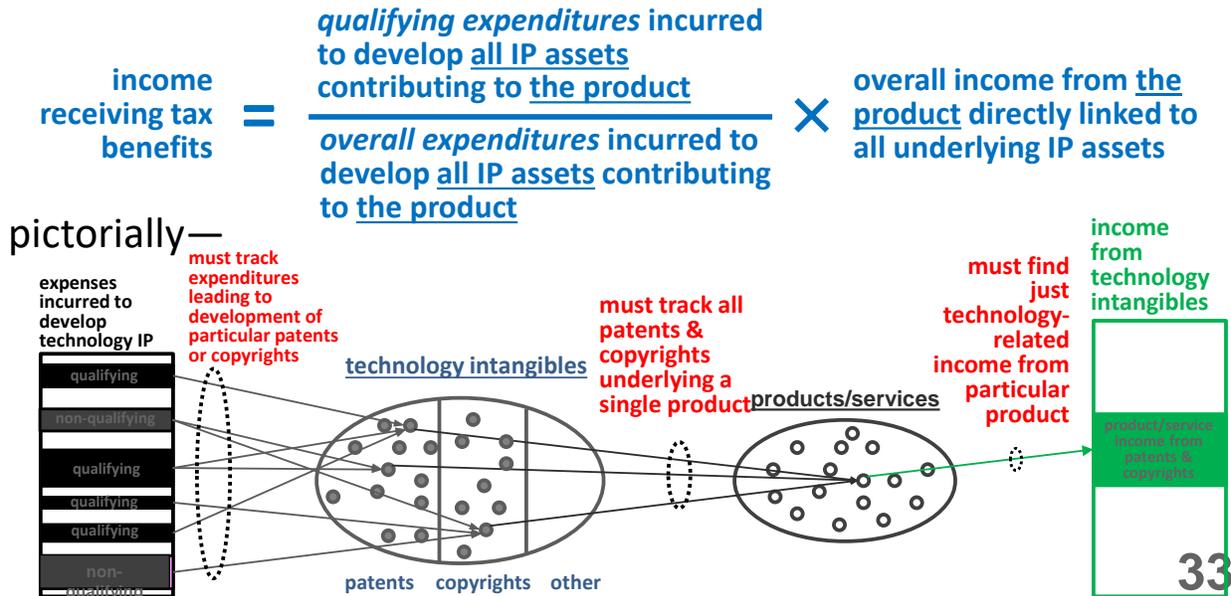
pictorially—



32

ACTION 5—SUBSTANTIAL ACTIVITY REQUIREMENT [CONT'D]

IP-based nexus approach 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 product-based nexus approach so that the nexus can be between expenditures, products (or product families) arising from IP assets, and income:



ACTION 5—SUBSTANTIAL ACTIVITY REQUIREMENT [CONT'D]

- ◇ **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, including unrelated-party outsourcing but excluding 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
 - must carve out income unrelated to IP assets (e.g., marketing and manufacturing returns)—e.g., using transfer pricing principles

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 <u>acquired</u> IP?	yes, if further developed and/or actively managed	partially, if further R&D work done by Irish co. on acquired IP
benefit <u>existing</u> 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	$71\% \times \text{lesser of } \left[\begin{array}{l} \text{innovation box profit for taxable year, or} \\ \text{taxable income for taxable year} \end{array} \right. \Rightarrow 10.15\% \text{ ETR}$
innovation box profit	$\frac{\sum_{5 \text{ years}} \text{taxpayer's U.S. R\&D expenditures}}{\sum_{5 \text{ years}} \text{taxpayer's total costs}} \times \text{tentative innovation profit}$
tentative innovation profit	$\text{qualified gross receipts} - \left[\begin{array}{l} \text{allocable} \\ \text{COGS} \end{array} + \begin{array}{l} \text{allocable} \\ \text{deductions} \end{array} \right]$
routine profit	routine and marketing profit implicitly <u>included</u> in tentative innovation profit
qualified gross receipts	gross receipts derived in the ordinary course of taxpayer's U.S. trade or business from the disposition of <i>qualified property</i> - certain exceptions
qualified property	(A) <i>patent, invention, formula, process, design, pattern, or knowhow</i> [§ 936(h)(3)(B)(i)] (B) <i>motion picture film or videotape</i> [§ 168(f)(3)] (C) <i>computer software</i> [§ 197(e)(3)(B)] (D) <i>a product produced using property described in (A)</i>
qualified services	gross receipts from services are <u>excluded</u> from <u>q.g.r.</u>
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 (border 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

37

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”:
$$100\% \times \text{R\&D costs}$$
$$+ 50\% \times (\text{R\&D costs not exceeding } \text{€}20\text{m})$$
$$+ 20\% \times (\text{R\&D costs exceeding } \text{€}20\text{m})$$

example €100m R&D expenses → deduction:

$$100\% \times \text{€}100\text{m} + 50\% \times \text{€}20\text{m} + 20\% \times \text{€}80\text{m} = \text{€}130\text{m}$$

⇒ 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.

38

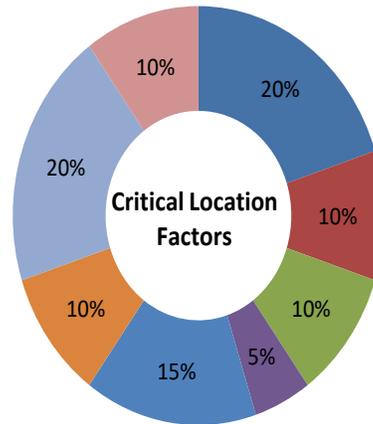
Asia Incentives

Tax Incentives – Typical Components

- ▶ Exemption/reduced tax on local profits
- ▶ Inbound withholding tax exemption
- ▶ Outbound withholding tax exemption
- ▶ R&D tax credit

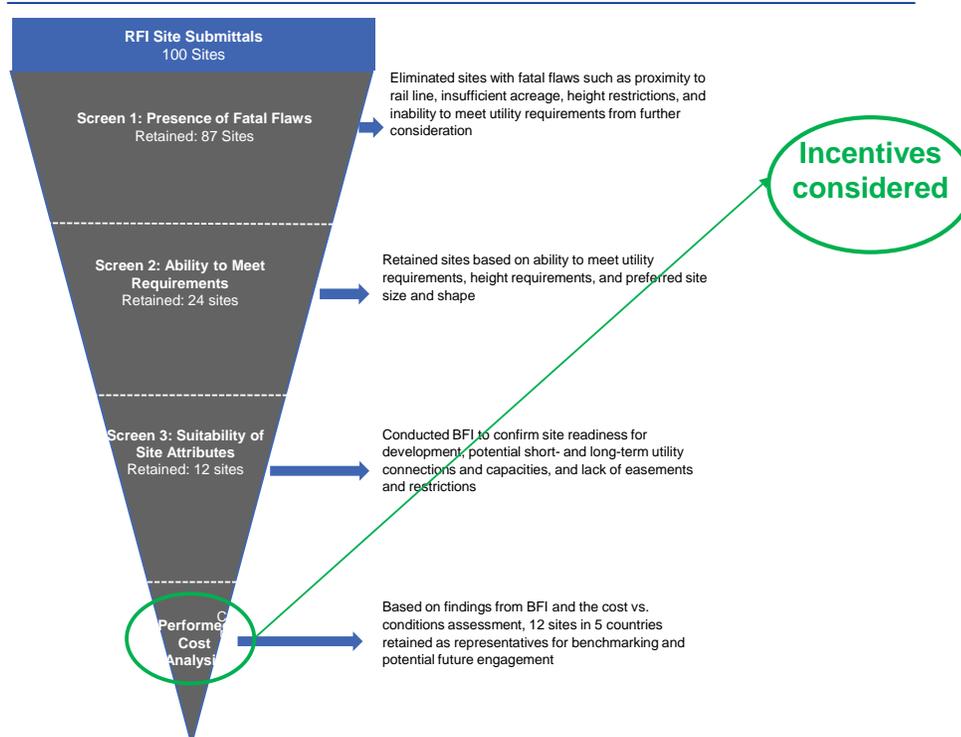
Asia Tax Incentives Overview

- ▶ An enhanced cost factor
- ▶ Frequent “tie breaker” vs. qualitative factors
- ▶ Interaction with non-tax incentives

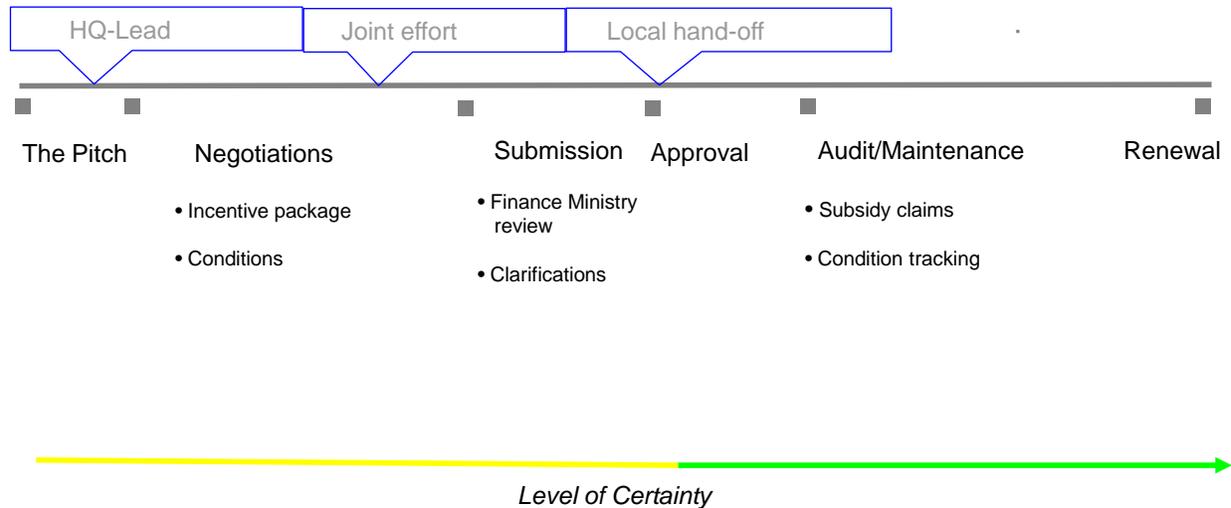


- Labor Quality and Availability
- Transportation Infrastructure
- Ecosystem
- Business Environment
- Regulatory Environment
- Real Estate
- Risk
- Utility Infrastructure

Location Screening Method



Tax Incentive Life Cycle



Tax Incentives – Negotiations Dos and Don'ts

- **DO** generate excitement beyond just jobs: the “Knowledge Economy” evolution
- **DO** remember “Negotiating with ally” dynamic
- **DO** push the envelope & be creative
- ▶ **DON'T** start until ready to commit
- ▶ **DON'T** leave local team out
- ▶ **DON'T** forget interaction with US rules and potential changes

Interaction with US rules

- ▶ Foreign tax credit: “soak-up” withholding tax (§§ 1.901-2(a)(3)(ii); 1.903-1(b)(2))
- ▶ Sub-part F
 - ▶ “Effective rate of tax” on **sales** income
 - ▶ Substantial Contribution as conditions
- ▶ Initial losses = E&P deficit?
- ▶ The theoretical DTL on depreciation difference

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



Questions?