2019: TAX OPPORTUNITIES AND CHALLENGES FOR MANUFACTURERS

Tax planning in an evolving environment

Wednesday, January 23, 2019
Our manufacturing focus

Manufacturing at RSM

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Today’s presenters

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## Agenda

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Why tax planning is urgent today

- Manufacturing sector strength
- Tight labor market, rising wages
- Digital transformation investments
- Tariff and trade tensions
- Tax reform
FEDERAL TAX
Highlights of issues for manufacturers
Business interest expense limitation

- Section 163(j) Limitation on business interest
  - Limited to sum of:
    - Business interest income
    - 30 percent of ATI
    - Floor plan financing interest
  - Indefinite carryforward
  - Applies at taxpayer level or consolidated tax return level, and includes special carryforward rules for partnerships
  - Does not apply to small businesses, electing real property trades or businesses, electing farming businesses and certain utility businesses
Business interest expense limitation

• Proposed section 163(j) regs issued November 2018
  • Broadly defines interest
    • Even if expense previously allowed under section 162
  • Mostly symmetrical with exceptions (e.g., anti-avoidance & debt issuance costs)
  • Depreciation capitalized to inventory under section 263A is not added back to ATI
    • Substantial potential impact for manufacturers
  • Interest expense capitalized under section 263A(f) is not subject to limit
  • YE provisions & 2018 tax compliance??
Capital expenditures and bonus depreciation

- **Rates**
  - 2018 – 2022: 100 percent
  - 2023 and beyond: phase out
    - 80% (2023), 60% (2024), 40% (2025), 20% (2026) 0% (2027 & later)

- **Expanded scope: New and used assets**
  - Significant mergers and acquisitions (M&A) impact when evaluating stock vs. asset structure.

- **Qualified Improvement Property (QIP) error**
  - Intent: 15-year recovery period and bonus eligible
  - Current: 39-year recovery period and not bonus eligible
  - Legislative “fix” will be required

- **Planning opportunity**
  - Partnership Sec. 754 Election: Basis adjustment under Section 743(b), purchase of a partnership interest, is bonus eligible; however, a basis adjustment under Section 734(b) is not bonus eligible
    - See Proposed Regulations issued in August 2018
  - Cost segregation study can maximize tax depreciation by identifying all bonus depreciable assets associated with larger real estate capital projects
Bonus depreciation caveats

- Acquired *and* placed in service after Sept. 28, 2017
- Like-kind exchanges of tangible personal property are no longer permitted
- Certain elections related to section 163(j) interest limitations require depreciation using the MACRS alternative depreciation system (ADS) which does not qualify for bonus depreciation
  - Electing real property trade or business and electing farm business
- Luxury automobile depreciation limitations are still applicable
- Taxpayer or predecessor must not have used the property at any time before acquiring it and the taxpayer must acquire the property by purchase
- Many states have decoupled from the Federal rules and require a recomputation
New UNICAP regulations

• Section 263A new regulations for treatment of costs capitalized to inventory issued November 2018
  • Inventory capitalization rules
  • Effective for tax years beginning on or after Nov. 20, 2018 (generally 2019)
  • Elective for tax year ending on or after Nov. 20, 2018 (generally calendar-year 2018)
  • Mostly impacts producers (minimally impacts resellers)
  • New definition of section 471 costs
    • General rule: type of costs capitalized for books, but based on amount of costs incurred during year for tax
    • Alternative rule, type AND amount based on books, but taxpayer must qualify
  • New modified simplified production method
New UNICAP regulations, cont.

<table>
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<th>Compare SPM to MSPM</th>
<th>Base</th>
<th>Adjustments</th>
<th>Adjusted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add'l 263A costs</td>
<td>9,750,000</td>
<td>10,000,000</td>
<td>19,750,000</td>
</tr>
<tr>
<td>471 Costs</td>
<td>100,000,000</td>
<td>-</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Absorption Ratio</td>
<td>9.75%</td>
<td>10.00%</td>
<td>19.75%</td>
</tr>
<tr>
<td>Gross end. inventory, current year (before reserves)</td>
<td>30,000,000</td>
<td>-</td>
<td>30,000,000</td>
</tr>
<tr>
<td>Add'l 263A costs in end. inventory under SPM</td>
<td>2,925,000</td>
<td>3,000,000</td>
<td>5,925,000</td>
</tr>
<tr>
<td>Compare to Add'l 263A costs in end. inventory under MSPM</td>
<td>2,788,889</td>
<td>1,079,861</td>
<td>3,868,750</td>
</tr>
<tr>
<td>Difference</td>
<td>136,111</td>
<td>1,920,139</td>
<td>2,056,250</td>
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**Why the difference?**

| Pre-production add'l 263A costs incurred during the year | 2,000,000 | 21% | - | 2,000,000 | 10% |
| Production add'l 263A costs incurred during the year    | 7,750,000 | 79% | 10,000,000 | 17,750,000 | 90% |
| Total add'l 263A costs incurred during the year         | 9,750,000 | 100%| 10,000,000 | 19,750,000 | 100% |
| Pre-production 471 costs remaining on hand at year end  | 10,000,000 | 33%| 10,000,000 | 20,000,000 | 67% |
| Production 471 costs remaining on hand at year end      | 20,000,000 | 67%| (10,000,000) | 10,000,000 | 33% |
| Total 471 costs remaining on hand at year end           | 30,000,000 | 100%| - | 30,000,000 | 100% |
Section 451(b) – the backstop

- Pre-tax reform section 451, income recognized earlier of:
  - Earned (via performance)
  - Due (contract terms/right to bill)
  - Received (actually or constructively)

- Tax reform added section 451(b): Recognize income NLT recognized in financial statements
  - Accrual basis taxpayers w/ AFS (i.e. audited)
  - Excludes special methods of accounting (installment sales, LT contracts, etc.)

ASC 606 for GAAP

- New accounting standard on revenue recognition
- Effective for private company’s beginning after Dec. 15, 2018 (i.e. 2019 calendar years)
- Tax impact: Tax uses books/records as starting point & requires consistency in applying tax accounting methods
- May need to file tax accounting method changes
  - Tax reform changes to section 451(b), effective 2018
  - ASC 606 changes, effective 2019… potential for two years of analysis for tax
Revenue recognition, cont.

Section 451(c) – the deferral

- Tax reform added section 451(c): Largely follows Rev. Proc. 2004-34 for advance payments/deferred revenue
  - Available to accrual basis taxpayer w/audited financial statements
    - RP 2004-34 applies even w/o audited financial statements (earned standard)
  - Limited to one year deferral
  - Applies to:
    - Goods
    - Services
    - Or similar item identified by the Secretary
  - Currently more limited than RP 2004-34
  - However, IRS has not revoked RP 2004-34
INTERNATIONAL TAX

Important considerations for the multinational manufacturer
Global intangible low-taxed income (GILTI)

- Starting in the 2018 tax year, new section 951A imposes a tax on 10 percent U.S. shareholders (individuals, corporations, partnerships, trusts) of controlled foreign corporations (CFCs) to the extent of such CFCs’ global intangible low-taxed income (GILTI)
- The inclusion of GILTI is generally treated in the same manner as traditional Subpart F income
- What’s in a name?
  - Global
  - Intangible
    - No direct connection to intangible assets
    - Applies to any CFC with profits regardless of industry
  - Low-Taxed
    - Not necessarily
  - Income
GILTI mechanics

- The calculation of GILTI is formula-based
- It allows for a 10 percent deemed return on the U.S. tax basis of certain tangible assets
- The residual income is deemed to be intangible income (whether or not that is actually the case) and is subject to current U.S. tax

- Basically 10 percent of NTV of fixed assets used in trade/business
- Requires quarterly ADS computations under U.S. rules

\[ \text{GILTI} = \text{Net CFC Tested Income} - \left[ (10 \text{ percent} \times \text{QBAI}) - \text{Net Interest Expense} \right] \]

Computed under U.S. taxable income computations

Net deemed tangible return
GILTI: C corp benefits

- U.S. C corporations are allowed to take a special deduction on the GILTI amount (new section 250)
  - The deduction is 50 percent of the GILTI amount (subject to TI limits) for taxable years beginning before Dec. 31, 2025
  - Coupled with a 21 percent tax rate for C corporations, the deduction results in an effective rate of 10.5 percent U.S. on GILTI for tax years before 2026
- U.S. C corporations are also allowed a reduced foreign tax credit against GILTI tax
  - No residual U.S. tax is owed on GILTI inclusion provided foreign effective tax rate is 13.125 percent or higher (assuming no expense allocation)
  - Note that proposed IRS regulations do require a complex expense allocation that may limit foreign tax credits

*Do you note any taxpayers that are missing here???
Observations on GILTI

• GILTI will impact almost every taxpayer that has ownership in a foreign corporation, including individuals, trusts, partnerships, S corporations and C corporations

• Section 250 deduction not allowable in calculating NOL and may result in existing NOL’s being absorbed more quickly

• GILTI may apply even if a taxpayer has no low taxed foreign earnings

• State and local taxation of GILTI inclusions will vary greatly among jurisdictions

• GILTI rules (coupled with new expanded Form 5471) will place a substantially larger reporting and compliance burden on all taxpayers
Foreign derived intangible income (FDII)

• New section 250 allows a special deduction from income of a U.S. C corporation that earns FDII

• For tax years 2018 through 2025, taxpayers may deduct 37.5 percent of their FDII which can result in this income being taxed at an effective rate of 13.125 percent
  – Starting in 2026, the deduction percentage shrinks to 21.875 percent thus increasing the overall effective rate to 16.406 percent
FDII: What income qualifies?

- Foreign-derived deduction eligible income: Any deduction eligible income which is derived in connection with
  - Property sold (or leased, licensed, or exchanged) to non U.S. persons for use, consumption, or disposition outside the U.S.; and
  - Services provided to any person, or with respect to property, located outside the U.S.
- Like GILTI, the computation is formula based and driven partially by fixed assets
Foreign sourcing of inventory sales

• Income from the sale of inventory property that a U.S. taxpayer produces in the United States and sells outside the United States (title passes outside the United States) is now treated as wholly U.S. source income (vs 50/50 U.S. and foreign)

• Taxpayers could see a reduction in their ability to utilize foreign tax credits as a result of a decrease in their foreign source income

• Example:
  • U.S. partnership manufactures and sells inventory to its U.K. disregarded entity. United Kingdom sells inventory to its U.K. customers
  • Under new rule, all the income from this transaction would be U.S. source income, and the ability to utilize the foreign tax paid in the United Kingdom would be limited
VAT trends

- VAT continues to expand around the world. Recent implementers include India, Saudi Arabia, UAE and Bahrain.

- Increasing numbers of countries are requiring overseas B2C suppliers of electronic services to register for and charge VAT locally.

- We are seeing the start of a move away from traditional compliance processes toward “real time reporting”, challenging many companies.

- The EU is implementing their “Definitive VAT System”, which will be the most significant change in European VAT in more than 25 years.

- Globally, VAT rates are on the rise, increasing taxpayers’ risk. Average rate in the EU is over 21%; globally it sits around 15%.
STATE TAX

Important changes with state taxing regimes
Federal reform impact on states

- Federal tax reform will have wide-ranging impacts on state FY20 budgets
- Federal tax reform changes will flow down to states or at least ‘trickle down’
- Conformity rules and timing are key
  - Over half the states conform to a specific date or on a rolling basis
- How will state respond?
  - Possible windfall for some states coupled to federal deductions that become eliminated
- Increased state compliance
Communication and planning is key

1. **Provisions effected**: Which domestic and international provisions are in effect?

2. **Conformity**: Has the state conformed to these provisions?

3. **Detail needed**: Are federal figures prepared with detail needed for state?
   - **Gross vs. net**: Income and deduction detail for certain provisions may be needed if state conforms to an income provision but not its related deduction provision.
   - **Separate filing states**:
     - Calculations by entity may be needed (consolidated vs. separate)
     - Intercompany interest expense and IRC 163(j)

4. **Planning and modeling**: Are tax implications understood; are tax savings captured?
What should you be thinking about?

• The state response to federal tax reform will continue in 2019 state legislative sessions and beyond

• Businesses must be cognizant of these issues
  • Choice of entity
  • M&A activity / new investments
  • Intercompany transactions
  • Foreign entities and transactions
  • Expansion and location
South Dakota v. Wayfair - recap

- Economic Nexus for Sales Tax collection
  - $100,000 of revenue, or
  - 200 or more transactions
- U.S. Supreme Court on June 21, 2018 overrules Quill in a 5-4 decision
  - Physical presence no longer required to establish substantial nexus
- Characteristics of the South Dakota law that prevent undue burden or discrimination against interstate commerce
  - South Dakota had adopted the Streamlined Sales and Use Tax Agreement
  - The rule is prospective only
  - Activity thresholds create small-seller exception
States that have addressed an economic sales tax nexus enforcement date

- Current economic SUT nexus
  - CA
  - OR
  - WA
  - NV
  - UT
  - AZ
  - NM
  - CO
  - MT
  - WY
  - ID
  - ND
  - SD
  - NE
  - IA
  - KS
  - MO
  - OK
  - TX
  - LA
  - AR
  - MS
  - AL
  - GA
  - NC
  - SC
  - FL
  - VA
  - WV
  - PA
  - MD
  - DC
  - HI

- Future economic SUT nexus
  - IN
  - IA
  - IL
  - WI
  - MI
  - OH
  - MI
  - IL
  - IN
  - TN
  - KY
  - KY
  - AL
  - WV
  - NC
  - NC
  - SC
  - SC
  - GA
  - GA
  - FL
  - VA
  - VA
  - WV
  - PA
  - MD
  - DC

- Cookie nexus with economic standard
  - NV
  - MT
  - WY
  - ID
  - ND
  - SD
  - KS
  - NE
  - OK
  - TX

- No action concerning Wayfair
  - MA

- No general sales tax
  - AK

*Massachusetts remote seller regulation in litigation in both Massachusetts and Virginia
Wayfair FAQ

• Will the states wait for Congress to act before enacting their own economic nexus provisions? Should businesses wait for Congress?

• Does registering for sales and use tax purposes in a state result in other tax exposure in that state?

• How to manage taxability and exemptions?

• Resource needs?
   • People – internal or outsource
   • Technology – ERP capability, tax rates, billing, reporting and compliance

• When does remote sales tax collection begin?

• What if I am not ready by the state enforcement date?
Wayfair FAQ

• Does physical presence still create nexus under economic nexus?
• What about use taxes? Do we still owe use taxes under economic sales tax nexus regimes?
• How are home-rule jurisdictions handled? Will a business need to achieve a separate threshold to be subject to that localities sales tax?
• Prior period exposure?
• Is there a need for a financial statement reserve?
• Will more states adopt the Streamlined Agreement?
• Will states honor other state exemptions?
Business incentives opportunities

**Tax incentives**
- Qualified Opportunity Zones
- Sales & use tax exemptions/refunds
- Federal and state enterprise zone credits
- Federal and state research and development credits
- Capital investment tax credits

**Hiring incentives**
- Wage rebates, job creation grants and credits
- Employment related incentives
- WOTC
- State point-of-hire credits
- Hiring and employee screening assistance

**Training benefits**
- Training grants for prospective training expenditures
- Development and implementation of training programs through state agencies
- Training tax credits (retroactive or prospective)

**Non-tax incentives**
- Infrastructure grants/assistance
- Low cost financing for capital expenditures
- Utility discounts
- Waiver of permit fees
- Expedited permits
- Free or discounted land/building

**Property tax relief**
- Negotiate real and personal property tax exemptions
- Structure Industrial Revenue Bonds (IRBs) for favorable property tax treatment
- Utility discounts
- Waiver of permit fees
- Expedited permits
- Free or discounted land/building

**Green incentives**
- Renewable energy investment and production credits
- Energy efficiency incentives and credits
- Incentives for LEED-certified buildings
- R&D and manufacturing incentives for green products

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Credits and incentives trends

- Lower federal tax rates, increased expensing, pass-through deduction, and repatriation are all contributing to increased domestic investment.
- Capturing the value of state and local credits and incentives is more important than ever.
- Increasing scrutiny from public pressure and state agencies to improve transparency and ensure public dollars used on incentive programs provide a good return on investment.
- FASB Topic 832 and IRC 118— which will require greater disclosures on: tax credits, incentives, grants, abatements, rebates, bond guarantees, refundable tax credits, statutory/negotiated incentives, etc.
Qualifying events for business incentives and triggers

- **Transaction driven**
  - Acquiring a new business operation

- **Company driven**
  - Creating new business operations
  - Expanding, realignment or relocation of facilities
  - Maintain existing facilities

- **Typical investments**
  - Construction, purchase, lease of new or expanded facilities
  - Purchase of new machinery or equipment
  - Infrastructure improvements
  - Hiring and retention of new or existing employees
  - Training of new or existing employees
THANK YOU

Please submit questions in the Q&A, and we will respond following the session
Contact your presenters

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