

# TECHNOLOGY AND TAXES

## Four Strategies to Balance Your Cash Flow

With proper planning, today's tax-saving moves can have a long-term, positive impact on the competitiveness and profitability of technology companies.

### INTRODUCTION

Even in an economy that seems to resist improvement at every turn, there are still avenues to boost cash flow, create opportunities and maintain acceptable levels of growth. Technology manufacturers, software developers and life sciences companies are attacking cash flow problems with targeted, proactive tax strategies designed to reduce effective tax rates and free up much-needed capital for investment in new production capabilities and people. With proper planning, today's tax-saving moves can have a long-term, positive impact on competitiveness and profitability.

Although there is no "one size fits all" approach to tax planning, there are at least four strategies worth considering for companies in technology industries:

- Research and Development Tax Credit
- Sales and Use Tax Issues
- IC-DISC Export Incentive
- Transfer Pricing Studies

### RESEARCH AND DEVELOPMENT TAX CREDIT

The Research and Development (R&D) Tax Credit is a federal incentive designed to keep jobs in the United States, encourage innovation, and reward efforts to improve productivity and competitiveness. Many companies qualify for extensive credits if their research expenditures meet certain federal requirements.

Many business owners and executives have heard of the R&D Tax Credit, but the nature of their business may have led them to believe they are not eligible. In addition, many businesses may not be taking as much of a credit amount as they are eligible to claim.

These R&D credits may be applied to taxes currently due, or to future tax liability. Unused current-year credits may be carried back one year and forward as far as 20 years. In addition, businesses can amend prior federal tax returns for up to three years and potentially claim tax refunds for those years.

#### What is Considered 'Research and Development?'

Any company that designs, develops or improves products, processes, techniques, formulas, inventions, or software is likely performing qualified research and development for the purposes of claiming tax credits. In addition, the investment of time, money, and resources toward the advancement and improvement of products and processes may qualify.

#### Software Companies

Software development companies are increasing their R&D activities as software services and service-oriented architecture are becoming more prevalent in the marketplace. Some examples of software development activities that may qualify for the credit include:

- Developing new or improved technologies
- Conducting requirements, domain, software elements or scope analysis for a new functional software enhancement
- Evaluating and establishing functional specifications
- Designing and developing the structural software architecture
- Establishing electronic interfaces and functional relationships between various software modules
- Programming software source code
- Compiling and testing source code
- Conducting unit, integration, functional, performance and regression testing

### Technology Manufacturing and Life Sciences

Today's technology and life sciences companies are ramping up new product development. These companies often spend a considerable amount of time and effort developing product designs that achieve optimized manufacturing process performance.

Some examples of activities that may qualify for the credit include:

- New product development
- Development of second generation or improved products
- Conducting tests to satisfy FDA, EPA, foreign or other regulatory requirements
- Innovations to improve product quality, yield or shelf-life
- Prototyping and three-dimensional solid modeling
- Designing innovative manufacturing equipment
- Implementation of automation processes or robotics
- Designing and developing cost-effective and innovative operational processes
- Integrating new materials to improve product performance and manufacturing processes
- Evaluating and determining the most efficient flow of material
- Designing and evaluating process alternatives
- Alternative material testing
- Developing and implementing new/improved safety enhancements
- Developing new applications
- Implementing new production standards and quality assurance processes
- Reducing manufacturing times
- Increasing operating and economic efficiencies

Claiming and maximizing the R&D Tax Credit requires a keen understanding of Internal Revenue Service documentation requirements and of the products and

processes for which the credit is being sought. The assistance of a skilled tax professional experienced in R&D incentives is recommended.

### IC-DISC EXPORT INCENTIVE

The United States provides a powerful tax saving opportunity for exporters in all industries. It is available to manufacturers and distributors, and to all forms of business organization, including C corporations, S corporations, partnerships, LLCs and sole proprietors. Taking full advantage of this incentive requires forming a new corporation for which a specific tax election is made.

#### What is IC-DISC?

U.S. tax law permits a corporation that has elected to be an Interest Charge-Domestic International Sales Corporation (IC-DISC) for a tax year, to be exempt from U.S. tax on qualifying profits from the export of U.S.-made goods and certain other income.

To qualify, an IC-DISC must:

- Meet certain minimal capitalization requirements
- Elect IC-DISC status for the year and subsequent years
- Meet a 95 percent export asset and income test
- Distribute at least all income in excess of that on the "best" \$10 million of qualifying sales
- Pay an interest charge on permitted undistributed income

A corporation organized in the United States may only elect IC-DISC status at its inception or at the beginning of a tax year. Therefore, a newly formed corporation is usually required.

The IC-DISC may distribute most or all of its income to its owners each year. Alternatively, the IC-DISC may defer the distribution of its income on the most profitable \$10 million in sales, if it can invest in sufficient qualified assets (such as export receivables). The shareholders of the IC-DISC must pay the U.S. Treasury a small interest charge for the privilege of any tax deferral — hence the name IC-DISC.

#### How it Works

Under present law, the IC-DISC effectively lowers the tax rate from 35 to 15 percent on the export profits transferred to the IC-DISC. The IC-DISC commission is deductible to the entity paying the commission, and distributions from the IC-DISC qualify for the current reduced tax rate on qualified dividends. In this way, an IC-DISC may lower the tax rate, or it may provide a tax deductible dividend. There is no minimum or maximum level of exports required to qualify for IC-DISC benefits if all profits of the IC-DISC are distributed.

## Example

Example: ExpCo, an S corporation, buys electrical hardware made in the United States and resells it to customers. Of its annual sales, \$15 million are to customers outside the United States. ExpCo's taxable income on those export sales is \$2 million, after allocating and apportioning all deductions. ExpCo's shareholders are in the 35 percent federal tax bracket and pay the same state income tax on all types of income. The ExpCo shareholders can save \$200,000 in taxes by implementing an IC-DISC, either owned by ExpCo directly or as a sister company. The IC-DISC will charge ExpCo a \$1 million commission, and pay a dividend to its shareholders of \$1 million.

Benefits for a C corporation that pays regular dividends can be even greater. If ExpCo were a C corporation and regularly distributed a dividend of \$1 million to its shareholders, then ExpCo would get a deduction for the IC-DISC commission of \$1 million, and the tax of the shareholders would remain unchanged. ExpCo would have additional net earnings of \$350,000.

## What is Involved?

To get started, an exporter must create a new corporation. Within 90 days, this corporation must file IRS Form 4876-A to elect IC-DISC status. The new IC-DISC must enter into a commission agreement with the seller of export goods ("related supplier") whereby the IC-DISC will receive a commission for certain specified services. The IC-DISC also agrees to have the "related supplier" perform the services on its behalf.

Under IRS regulations, the IC-DISC is allowed to earn a profit of the greater of 50 percent of export profits or 4 percent of export sales (subject to certain limitations), plus 10 percent of certain export promotion expenses. The profits in question are determined by subtracting the cost of qualifying property from sales of export property. Such gross income is further reduced by all deductions of all related suppliers that are properly allocable and apportionable to such sales. IRS regulations provide detailed rules for allocating and apportioning deductions, with special rules applying for interest, research and experimentation, and state income tax deductions. All gross income and deductions are computed on the same basis as used in preparing tax returns of the related supplier(s).

## Qualifying Sales

IC-DISC benefits are available only with respect to sales of property made in the United States and certain services, where such goods or services are for ultimate use outside the United States. To qualify, the final portion of manufacturing of goods must have taken place in the United States. In addition, foreign content cannot exceed 50 percent of the total fair market value. In the event there are imported items, in no case is less than 20 percent of the total cost of goods sold of the export property attributable to United States conversion costs.

IC-DISC benefits are available to every person in the supply chain for U.S.-made goods that are exported. The IC-DISC's related supplier need not be either the manufacturer or the exporter. However, the taxpayer must demonstrate that the goods meet the "manufactured in the United States test," and the foreign use test. Certain presumptions in the regulations may aid in meeting such tests. A wholesaler who purchases goods from a manufacturer in Ohio and sells the goods for direct shipment overseas can easily qualify, as can the manufacturer if the wholesaler provides the required documentation.

## Optimizing the Benefits

IRS regulations provide several rules which can improve the basic result, but require significant additional calculation effort. The IC-DISC regulations provide that calculations may be made on a transactional, grouped or aggregate basis. This enables taxpayers, with sufficiently sophisticated calculation tools, to further optimize benefits by making calculations using multiple methodologies.

## SALES AND USE TAX ISSUES

State sales and use taxes are complicated at best, and incomprehensible at worst, but they remain a fact of business life. For some companies, a failure to implement and apply proper sales and use tax practices may represent a significant deficiency which, in addition to significant penalties and interest assessed by taxing authorities, can cause issues in financial reporting or during due diligence for acquisitions.

Innovation in the technology and software industries has created even more difficulty and ambiguity in the sales and use tax arena. Technology, life sciences, and software companies must be fully aware of their potential sales and use tax exposure and the impact that taxes can have on their businesses.

## Step 1: Exposure Analysis

### Nexus:

States can only assess tax on a company if the company has “nexus,” or physical presence in the jurisdiction. Every state has different laws and regulations regarding what constitutes nexus, further clouding a company’s taxing requirements. A company’s activities must be reviewed and evaluated in light of the states’ laws, regulations and court cases to determine when states have taxing authority.

### Taxability:

Once nexus is determined for a particular state, the question is whether a company’s product or service is subject to tax in the particular state. Historically, only “tangible personal property,” or physical goods, has been subject to sales tax. The digital era has created issues for states in applying their traditional tax laws. States are under pressure to adapt their laws to the information age; therefore, more types of transactions are becoming subject to tax. Software delivered electronically through an internet “cloud” model (SaaS) is one example of transactions that states treat inconsistently for sales tax purposes.

Purchasers of taxable goods and services must also be cognizant of sales tax laws. If sales tax is not charged by a seller to a purchaser for a taxable transaction, the purchaser still has a use tax liability in the state where the goods or services are delivered or used.

## Step 2: Risk and Liability Mitigation

Once tax exposure is determined for a company, an assessment should be made as to the potential liabilities associated with non-compliance by a company in past years and the risks going forward. If a company has never filed appropriate tax returns, states can typically assess prior tax as far back as authorities deem it is owed, with no statute of limitations.

There are remedies to limit potential tax liabilities, penalties and interest for prior non-compliance. Companies can enter into voluntary disclosure agreements with the state taxing jurisdictions. Benefits of a voluntary disclosure agreement include:

- Limited look-back period for the state taxing jurisdiction, resulting in substantially less tax assessed
- Waiver of penalties, and occasionally interest, on unpaid taxes
- Company stays anonymous until the agreement is consummated with the state

## Step 3: Ongoing Compliance

In addition to the immediate benefit of reduced tax exposure and liabilities, companies should be more effective in their compliance procedures going forward to reduce the risk of unknown or unpaid tax liabilities in the future.

## TRANSFER PRICING

Transfer pricing is an integral component of a multinational corporation’s global strategic planning and decision-making processes. Multinational corporations regularly transact business with affiliates in different countries involving different taxing authorities. The taxing authority in each country insists (via transfer pricing regulations) that the corporation pay its “fair share” of taxes for each of these cross-border transactions, including those involving tangible products, as well as intercompany loans, a variety of services, intellectual property and other intangible assets.

The global economic downturn has most taxing authorities throughout the world searching for additional sources of tax revenue. Many are looking to transfer pricing as a source for this additional revenue. The method most commonly used is increased enforcement of new and existing transfer pricing regulations via transfer pricing audits. In the United States, the IRS has made transfer pricing a Tier One issue, and has dramatically increased the number of transfer pricing audits. The IRS plans to further increase the number of “international specialists” focused exclusively on transfer pricing and other international transactions.

Who is at risk for a transfer pricing audit? In short, any company with a foreign parent that purchased or sold goods or services to/from its parent, and any company with foreign subsidiaries that it sold/purchased goods or services to/from its subsidiaries.

### What is Transfer Pricing?

Transfer pricing represents the prices charged by related parties to each other. It includes transfers of intellectual property, provision of services, transfers of tangible goods, and transfers of loans and other financing transactions.

Many multinational corporations are able to save taxes by structuring the functions and risks of intercompany transactions so that most of the profit from the transaction goes to the lower tax jurisdiction.

For example, a U.S. parent company (paying tax at 35 percent) sells widgets to a Hong Kong distribution subsidiary. Because the U.S. tax rate of 35 percent is greater than the Hong Kong tax rate of 16 percent, the U.S. parent will want to price the widgets as low as possible so that the Hong Kong subsidiary can capture most of the profit on the resale of the widgets in Hong Kong. By employing the appropriate pricing principles, multinational corporations can price products so that the minimum amount of tax is paid, while still complying with the transfer pricing regulations of both countries.

Transfer pricing audits, adjustments and penalties, and defense against taxing authority actions of all sorts, can be costly. Multinational corporations can take steps to mitigate these costs through their transfer pricing policies, analysis and documentation.

The rules of the game are complex. Among the services that can help avoid hefty penalties and produce cost savings are:

- Transfer pricing documentation
- Functional and risk analyses
- Economic intercompany pricing and interest rate analyses
- State-to-state transaction analysis
- Developing global transfer pricing policies
- Advanced pricing agreements
- Cost-sharing agreements
- Dispute resolution

### **Transfer Pricing Documentation**

Contemporaneous transfer pricing documentation is the primary method by which taxpayers avoid transfer pricing penalties. Generally, these penalties automatically apply if contemporaneous documentation is not provided. In the United States, the penalty, equal to 20 to 40 percent of any additional tax, applies when either:

- An intercompany transfer price was less than 50 percent or more than 200 percent of the “arm’s length” price, or
- The transfer pricing adjustment increases taxable income by \$5 million or more

Documentation must meet strict global compliance standards, and typically requires the knowledge, experience and technology of a transfer pricing specialist.

### **Functional and Risk Analysis**

A key element of any transfer pricing documentation is a detailed and well-documented functional and risk analysis, which is used to determine whether controlled and uncontrolled transactions are comparable based on an arm’s length price (as required by U.S. Treas. Reg. §1.482-1). Overall, the functional and risk analysis is intended to be a detailed fact-gathering process and an assessment of the overall corporate operation and associated risks. The functional and risk analysis relies on a working knowledge of the industry, marketplace, and the entity itself, to evaluate the entity’s functions in terms of capital, labor and economic risk exposure that may give rise to profits.

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### **Economic Intercompany Pricing and Interest Rate Analysis**

The application of the arm’s length standard is the cornerstone of transfer pricing documentation and disputes. In short, the arm’s length standard states that the price charged by related parties be the same as that which would be charged to unrelated parties.

A miscalculation can have severe financial impact on a multinational corporation as a result of double-taxation penalties and dispute resolution costs. It is recommended that the corporation work with transfer pricing specialists who have consultative knowledge, experience, and technology to apply advanced analytical techniques to economic intercompany pricing and interest rate analysis.

### **State-to-State Transaction Analysis**

Cash flow and cash savings are important priorities for corporate finance departments. Through analysis of transactions, and specific state rules and regulations, it is possible to create a cost-efficient state-to-state transfer pricing strategy.

### **Developing Global Transfer Pricing Policies**

An effective global transfer pricing strategy must provide the arm’s length pricing of tangible goods and services, and the transfers of intangible assets from the perspective of U.S. and non-U.S. taxing authorities, while reducing the risk of tax authority challenges and maximizing tax

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efficiencies. A multidisciplinary team of valuation experts, economic experts, and tax specialists is required to address the organization's specific needs and risks.

### Advanced Pricing Agreements (APA)

An APA is the preferred way for a U.S. taxpayer to maximize tax reductions, while minimizing exposure to transfer pricing penalties. Although APAs have traditionally only been used by large companies, the IRS has issued streamlined procedures to make the process more cost-efficient for mid-size and small companies.

APAs include a set of critical assumptions that, if followed, will prevent any examination by the IRS of a company's transfer pricing study for three to five years. In the APA program, the taxpayer and the IRS prospectively agree to the taxpayer's facts, transfer pricing methodology and an arm's length range of results.

### Cost-Sharing Agreements

Experts in research and development, intellectual property valuation, and taxes can work together to develop an extensive analysis for all of an organization's U.S. and foreign research projects. The organization can then comply with multiple tax jurisdictions and plan for the future.

### Dispute Resolution

Disputes are bound to arise, even in situations where the taxing authorities have proposed a transfer pricing assessment.

For example, a transfer pricing dispute arose between the Canadian Revenue Agency (CRA) and a \$3 billion U.S. manufacturer regarding management fees charged to a Canadian manufacturing facility by its U.S. headquarters. The company had not changed a management fee structure that had been accepted by the CRA in a 1997 audit. In late 2008, the CRA audited the 2003–2004 Canadian tax returns and proposed audit adjustments totaling \$4 million for those years. The company had additional exposure of \$23 million for unaudited open tax years through 2008.

A consultant analyzed cost structures and the controlled services provided to the Canadian operation by the U.S. headquarters. An analysis indicated that the charges were reasonable, given the services provided. Management submitted the analysis and report to the CRA, which reviewed, tested and subsequently concurred with the analysis. The result was no assessment for 2003–2004, and no exposure for 2005–2008.

## CHOSING THE RIGHT STRATEGIES FOR YOUR COMPANY

Reducing tax liabilities will not solve all of a company's cash flow issues, but in some cases, it can free up much-needed cash for more pressing needs. Not all of these strategies will yield the same results for every company, but they are worth considering as a key element in planning for surviving and thriving in a down economy.

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