

The 13th Annual Americas School of Mines Cash Tax Optimization: Hot Topics in a Cool Economy*

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Agenda/Contents

- General Principles of Tax Accounting Methods
- Possible Tax Accounting Method Changes
- Additional Cash Tax Opportunities

Accounting Methods – In General

What is an accounting method?

- Overall Method
- Individual Items

An accounting method has two characteristics (Section 446):

(1) Timing

(2) Consistency

Accounting Methods – In General (continued)

Timing

- Most important characteristic of an accounting method
- Determines year in which income or expense is reported (i.e., lifetime taxable income unchanged)

Consistency - allows for certainty and predictability

Accounting Methods – In General (continued)

Taxpayer considered to have adopted an accounting method (Rev. Rul. 90-38) if:

- Proper method used in a single return; **or**
- Erroneous method consistently used in at least two consecutive returns

Foreign taxpayer adopts a method the first taxable year in which method is “significant” for E&P purposes. See Treas. Reg. section 1.964-1T(c).

- Method change rules generally apply to foreign corporations in the same manner as domestic corporations

NOTE: A correction of an error, change in character, or a change in fact is NOT a change in method

Accounting Method Change Procedures

Why file a request to change a tax method of accounting?

- Different, proper tax accounting method would provide greater benefit
- Current tax accounting method is improper – filing method change, generally provides audit protection for past years
- Involuntary method change resulting from exam results in (Rev. Proc. 2002-18):
 - Exam agent determining new method
 - Change made in earliest open year (with certain exceptions)
 - 481(a) adjustment included entirely in the year of change

NOTE: Cannot change method without requesting permission

Accounting Method Change Procedures (continued)

Comparison of Non-automatic and Automatic Changes:

	Rev. Proc. 97-27	Rev. Proc. 2008-52
Due Date	Last Day of Taxable Year	With Original, Timely Filed Tax Return
481(a) Spread for Negative Adjustment	1 – Year	1 – Year
481(a) Spread for Positive Adjustment	4 – Years	4 – Years
IRS Filing Fee	\$3,800 (plus \$90 for each additional legal entity)	None
Where to File	File with IRS National Office	Original with Tax Return; Duplicate with IRS National Office

Accounting Method Change Procedures (continued)

- Generally can't file if under examination, but exceptions exist:
 - 90-day window (first 90 days of taxable year if under exam for 12 consecutive months as of the first day of the taxable year, if issue being changed is not "under consideration")
 - 120-day window (120 days after the end of an examination, if issue being changed is not "under consideration")
 - Director consent (rarely for a positive §481(a) adjustment)
 - Change without audit protection
 - Issue pending without audit protection

If an exception applies, generally required to send copy to revenue agent, appellate conferee, and/or district counsel (as applicable)

Effects of Cash Tax Opportunities

- Cash tax opportunities may also affect a company's section 263A and/or percentage depletion calculations
- It is important to consider overall tax position, including ancillary effects of these potential cash tax opportunities before implementing

Possible Tax Accounting Method Changes

Advance Payments

Bad Debts

Accrued Compensation Liabilities

Employment Taxes

Prepaid Payment Liabilities

Prepaid Services or Goods

Software Development Costs

Self-insured Medical Accruals

Reclamation Costs

Repairs and Maintenance

Spare Parts

263A

Advance Payments

- **What taxpayers often do:** Recognize income from advance payments upon receipt
- **Best tax method:** Recognize advance payments in accordance with Rev. Proc. 2004-34 (for services) and Treas. Reg. section 1.451- 5 (for goods)
- **How to identify:** Deferred revenue liability on the balance sheet and deferred tax asset related to the deferred revenue liability

Advance Payments (continued)

Examples of advance payments to which this applies:

- Advance royalties
- Advance software maintenance and license fees
- Advance payments for services
- Advance payments for inventorable goods

Special Applications:

- Sales credits
- Multi-year contracts
- Partially qualifying terms

Bad Debts

What taxpayers often do: Deduct when charged-off (i.e., fluxing the reserve)

Best tax method: Deduct when specific reserve is established for the item, or when debt is wholly worthless

How to identify: Doubtful accounts contra asset on the balance sheet and deferred tax asset related to the doubtful accounts contra asset

Accrued Compensation Liabilities

- What taxpayers often do:** Deduct liability for accrued compensation items (e.g., wages, commissions, vacation pay, bonuses, severance) when paid
- Best tax method:** Deduct when services provided if paid within 2 ½ months of year end
- How to identify:** Compensation items (e.g., wages, commissions, vacation pay, bonuses, severance) accrued on the balance sheet and deferred tax asset relating to the compensation liabilities; also review contents of any restructuring reserves
- Special Considerations:**
- Bonus Compensation
 - January 1 Holiday Pay
 - Severance costs included with restructuring reserve

Employment Taxes

- **What taxpayers often do:** Deduct employment taxes in the year compensation is paid
- **Best tax method:** Accrue employment taxes associated with fixed and determinable year-end compensation to the extent all events have occurred and taxes are paid by the earlier of the taxpayer's timely filed (including extensions) tax return or within 8½ months of year-end
- **How to identify:** No employment tax liabilities or understated employment tax liabilities (relative to the accrued compensation) on the balance sheet and no deferred tax liability for employment taxes

Prepaid Payment Liabilities – 12 Month Rule

What taxpayers often do: Capitalize and amortize over life of prepayment

Best tax method: Deduct certain prepaid payment liabilities (e.g. insurance licenses, fees, permits, software maintenance) upon payment

How to identify: Prepaid assets on the balance sheet and no deferred tax liability related to the prepaid assets

Prepaid Services or Goods

- **What taxpayers often do:** Capitalize and amortize prepaid services or goods over life of the prepaid amount
- **Best tax method:** Deduct prepaid services or goods if reasonably expect to receive within 3 ½ months of payment (“Cliff Rule”)
- **How to identify:** No deferred tax liability
- **Note to consider:** “Payment Due” requirement (Rev. Rul. 2007-3)

Software Development Costs

What taxpayers often do: Capitalize and amortize

Best tax method: Deduct software development costs as incurred

How to identify: Large amount of software development costs capitalized on the balance sheet and no deferred tax liability related to the software development costs

Self-insured Medical Accruals

What taxpayers often do: Reverse IBNR reserve for self-insured medical expenses

Best tax method: Deduct self-insured medical IBNR when services are provided

How to identify: Book/tax adjustment for self-insured medical expense

Reclamation Costs

- **What taxpayers often do:** Deduct the costs for reclamation services when paid
- **Best tax method:** Deduct the cost of reclamation services provided within 8-1/2 months of year end in accordance with Treas. Reg. Section 1.461-1(a)(2)(i). (Only applies to taxpayers who do not elect the provisions of IRC Section 468 for accounting for reclamation expense.)
- **How to identify:** Payable for reclamation costs on the balance sheet and a deferred tax asset related to the payable

Repairs and Maintenance

What taxpayers often do: Capitalize costs that may be treated as deductible repairs for tax purposes.

Best tax method: Deduct costs of incidental repairs incurred in connection with the routine repair and maintenance of their assets. In the mining industry, repairs are frequent and substantial in costs due to parts coming in contact with the earth.

How to identify: For federal income tax purposes, taxpayer is following its book method of accounting for costs incurred in performing incidental repairs and maintenance and could be capitalizing more costs than required under Reg. Secs. 1.263(a)-1(b) and 1.162-4

Spare Parts

- ▶ **What taxpayers often do:** Depreciate spare parts when the parts are used to replace a defective component of machinery and equipment
- ▶ **Best tax method:** Begin to depreciate qualifying spare parts when the parts are made available for use. In addition, some parts may qualify as materials and supplies that may be expensed when made available for use.
- ▶ **How to identify:** Capitalized spare parts on the balance sheet with no associated depreciation deduction on the income statement

Section 263A Capitalization

General Principles of §263A

- Provides uniform rules for capitalization of costs to:
 - Real and tangible personal property produced, and
 - Real and personal property acquired for resale
- Applies to both inventory and self-constructed assets (i.e., assets produced for sale or use within the taxpayer's business).
- Generally requires taxpayers to capitalize costs over and above those which are being capitalized for book purposes.

Section 263A Capitalization (continued)

Typical Book/Tax UNICAP Cost Differences:

- Practical capacity (FAS 151)
- Standard cost variances
- Offsite warehousing costs
- Distribution costs
- Pick and pack labor
- Royalties and licensing costs
- Environmental costs
- G&A (mixed service) costs
- Schedule M adjustments (e.g., depreciation, pension, stock options/FAS 123, bonuses)

Section 263A Capitalization (continued)

- Requirements of IRC Section 263A and the UNICAP regulations are complex, and taxpayers often find compliance burdensome.
- Heightened scrutiny of the IRS related to uniform capitalization increases the need for taxpayers to review their 263A computations.
- An improper method could result in IRS adjustments to prior tax returns, assessments of additional taxes, interest, and penalties.

Additional Cash Tax Opportunities

Fixed Asset Income Review

Bonus Depreciation

Monetization of Unused AMT and R&D Credits

Reclamation

Research and Experimentation Credits

Managing Accounts

Section 199 Review

Reverse Sales & Use Tax Audit

Computing Corporate Estimated Tax Payments

Additional Carryback Period for NOLs

Multistate Tax Credit Review

Transaction Cost Analysis

Canadian Indirect Tax Review

VAT Cash Savings

Fixed Asset Income Review

Issue:

- Taxpayers often under-depreciate depreciable property that has been misclassified as property with a longer life than appropriate, which provides a lower depreciation deduction in earlier years.
- Examples of misclassified property are:
 - Personal property capitalized in the cost of real estate
 - Buildings whose sole purpose is to accommodate equipment
 - Leasehold improvements which include Section 1245 property

Action:

- Taxpayers should review their classification of fixed assets

Impact:

- Companies may be able to accelerate depreciation deductions by appropriately classifying depreciable property as property with a shorter life.

Bonus Depreciation – Background

Economic Stimulus Act of 2008 and The American Recovery and Reinvestment Act of 2009 temporarily reenacts the additional 50% first-year depreciation deduction in § 168(k) ("bonus depreciation")

Four Requirements

1. Qualified property
2. Taxpayer must be the original, or first, user of the property
3. Property must be placed in service by 12/31/09 (12/31/10 for Longer Production Period Property (LPPP) and certain aircraft)
4. Acquired in 2008 or 2009

Bonus Depreciation – General Considerations

- Mandatory application of bonus depreciation unless elect out
- Bonus depreciation applies for AMT purposes (no Reg Tax/AMT difference for remaining depreciable basis of assets that qualify for bonus)
- There is no income limitation or investment limitation on bonus depreciation allowance
- Adjusted basis of qualified property acquired in a like-kind exchange or an involuntary conversion is eligible for bonus depreciation
- Bonus depreciation rules do not apply for purposes of computing E&P
- No short-year adjustments for bonus depreciation
- For fiscal year taxpayers bonus depreciation is applicable to calendar-year 2008 and 2009 additions

Monetization of Unused Pre-2006 AMT and R&D Credit Carryforwards

Issue:

- The Housing and Economic Recovery Act of 2008, signed into law on July 30, 2008, allows companies to elect to accelerate or “monetize” a portion of their unused pre-2006 Alternative Minimum Tax (“AMT”) and research and development (“R&D”) tax credit carryforwards in lieu of claiming the 50-percent bonus depreciation for eligible qualified property (“EQP”) acquired between March 31, 2008 and December 31, 2009.
- The American Recovery and Reinvestment Act extended the monetization of R&D and AMT credits to 2009.

Impact:

- Companies may be able to:
 - Claim credits that otherwise might expire;
 - Monetize the refundable accelerated credits; and
 - Increase their cash flow.
- Because mining companies may be perpetually subject to AMT, this may be an opportunity to recover these credits.

Monetization of Unused Pre-2006 AMT and R&D Credit Carryforwards

Other Considerations:

- Some of the factors that companies must consider before electing into this new provision are:
 - How to calculate “bonus depreciation”;
 - Net present value of straight-line depreciation recovery period versus a bonus depreciation plus MACRS depreciation recovery period;
 - Limitations on the amount of unused credits that may be monetized;
 - How to claim the refundable credits;
 - How to decide whether to elect monetization of credits or utilize bonus depreciation; among others.
- **For companies that :**
 - Have significant AMT and/or R&D tax credit carryforwards occurring from tax periods beginning before January 1, 2006;
 - Are in an AMT or NOL position; and
 - Expect significant spending on capital expenditures between April 1, 2008 and December 31, 2009.

Reclamation Costs

IRC Section 468:

Issue:

- Under IRS section 468, mine operators are allowed to accrue and deduct expenses for mining reclamation and closing costs in the current year (in advance of economic performance).
- The Code requires that separate reserve accounts be established for mine reclamation and closing costs. The taxpayer must elect to accrue these expenses.
- Interest is accrued on the reserve account balances under the Federal Short Term Rate determined by IRC section 1274.
- If the election is revoked, the taxpayer must recapture the remaining reserve account into income.

Action:

- Taxpayers should determine whether a section 468 election would be beneficial.

Impact:

- An election under section 468 may provide a cash tax savings opportunity for taxpayers in the mining industry.

Research and Experimentation (“R&E”) Tax Credit Study

- A R&E Tax Credit Study identifies, documents, and defends all qualifying research and development activities and related expenses.
- The research credit under Section 41 was enacted to help stimulate and subsidize the design and development of new and improved products and manufacturing processes.
- For taxable years ending after 12/31/2007, taxpayers have the option to choose from three credit calculation methods: Regular Research Credit, Alternative Incremental Credit (AIRC), or New Alternative Simplified Credit (ASC).
- The Emergency Economic Stabilization Act of 2008 retroactively extended and modified the Section 41 Research Tax Credit as follows:
 - The Research Tax Credit was extended retroactively to January 1, 2008, for 2008 and 2009.
 - For the ASC method the rate was increased from 12 percent to 14 percent for taxable years ending in 2009 (12 percent in the case of taxable years ended in 2008).
 - The AIRC was terminated for taxable years beginning after December 31, 2008.

Managing Accounts – Uncovering Interest Errors/Refund Opportunities

Issue:

- Tracking the IRS transactions among taxpayers and tax periods is often a difficult task that requires tax personnel to monitor the entire tax account.
 - Incorrect interest calculations by the IRS can result in companies paying considerably more interest than they actually owe.
 - Finding and correcting these errors is further complicated by the highly technical nature of interest issues and constant changes in governing code sections, rulings and court decisions.

Action:

- PwC's Managing Accounts team may assist companies in identifying and recovering interest overpayments.

Impact:

- Companies may be able to recover funds and maintain current and accurate IRS accounts reducing potential costly future problems and financial risk by eliminating additional interest and/or penalties.

Section 199 Deduction

Issue:

- The provisions of Section 199 deduction are complex and many companies may have difficulty calculating and properly documenting the impact of the provision.

Action:

- Section 199 deduction analysis may assist companies in implementing measures to fully take advantage of the available benefits of the Section 199 deduction.

Impact:

- Companies may be able to:
 - Identify qualifying revenue streams and appropriate accounting methods for the deduction;
 - Obtain permanent tax savings, and thus, increase cash flow;
 - Streamline current record-keeping and documentation systems to meet IRS documentation requirements;
 - Understand the deduction's impact on their financial statement; and
 - Develop a comprehensive action plan to obtain and support ongoing savings, among other benefits.

Section 199 Deduction (continued)

Other Considerations:

- The Section 199 deduction, designed to promote domestic manufacturing, provides a permanent tax benefit to companies with qualified production activities income (QPAI), and represents an important cash savings opportunity, as the deduction will increase from the current 6% of QPAI to 9% in 2010 and beyond.
- Many companies may be overlooking the application of Section 199 to their current activities.
- For all corporations, partnerships, sole proprietorships, estates and trusts that provide or produce in whole or significant part in the U.S. the following:
 - Tangible personal property;
 - Computer software, and sound recording;
 - Motion pictures and television productions;
 - Electricity, natural gas, or potable water;
 - Construction; and
 - Engineering or architectural services.

Reverse Sales & Use Tax Audit

Issue:

- The complexity and changes in sales and use tax laws make it impractical for most companies to stay informed of all exemption opportunities and filing requirements.
 - Companies may be unaware of all available exemptions and may also lack in-house specialized resources to claim all the exemptions for which they are eligible.
 - Accordingly, companies may be significantly overpaying sales and use tax.

Action:

- A reverse sales and use tax audit analyzes a company's past purchases to determine whether sales or use tax was improperly paid on items that would qualify for an exemption, e.g. a manufacturing exemption, or a shipping exemption.

Impact:

- Companies may be able to:
 - Recover "lost" tax dollars;
 - Offset audit assessments;
 - Reduce future overpayments; and
 - Identify appropriate steps to mitigate exposure due to underpayments of sales and use taxes.

Computing Corporate Estimated Tax Payments

Issue:

- On August 7, 2007, the IRS issued final regulations under Section 6655, addressing the annualized income installment method for computing estimated tax payments.
 - The issuance of these final regulations likely will create a change in practice for almost all companies that avail themselves of the annualized income installment method, in particular those companies that followed the short taxable year approach for determining the annualized taxable income.
 - Companies may not realized that new opportunities may exist under the final regulations to reduce estimated tax payments.

Action:

- PwC can work with companies to understand and comply with the variety of complex and different rules under the final regulations when computing their estimated tax payments.

Impact:

- Companies may be able to reduce their estimated tax payments, increase their cash flow, avoid penalties, and comply with the final regulations.

Computing Corporate Estimated Tax Payments (continued)

Other Considerations:

- For companies who determine their quarterly estimated tax payments based on annualized taxable income.
- Companies may be able to file Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax, if the corporation has an overpayment of at least 10 percent of the expected tax liability and is at least \$500.
- The final regulations are intended to allow a company to compute the most accurate picture of its annualized taxable income based on the facts that are known as of the end of the annualization period.
- One of the most significant new rules is that the annualization period is no longer treated as a short taxable year for purposes of determining annualized taxable income of an annualization period.
- Under the final regulations, annualized taxable income is primarily based on items of income and expenses incurred within the annualization period.

Computing Corporate Estimated Tax Payments (continued)

Other Considerations, Continued:

- Special rules apply to a variety of items of income and deduction that potentially could distort a company's annualized taxable income, such as:
 - "Specific deductions" (i.e., bonuses, pensions, and other deferred compensation items);
 - "Extraordinary items" (i.e., net operating loss carryovers);
 - Items that substantially affect taxable income (i.e., Section 199 deductions); and
 - Changes in method of accounting.
- The final regulations provide rules for taking into account credits earned during the taxable year, credit carryovers, depreciation and amortization, items that substantially impact taxable income but cannot be determined accurately by the estimated tax payment due date, advance payments, 52/53 week taxable years, initial taxable years, and short taxable years.

Additional Carryback Period for NOLs

Issue:

- Generally, a company that incurs a NOL during a year must carry the loss back 2 years and then forward to the succeeding 20 years.
- An exception to the general 2-years carryback period applies in the case of NOL attributable to a specified liability losses (“SLLs”), which may be carried back 10 years.

Action:

- PwC can assist companies in improving the use of SLLs by evaluating a company’s facts and circumstances and determining what 10-year carryback opportunities may exist.

Impact:

- Companies may obtain significant tax savings and an increase in cash flow.

Multistate Tax Credit Review

Issue:

- To stimulate local economies, state and local governments are constantly increasing the diversity of cost-savings opportunities offered to companies that conduct or will conduct business in their region.
- Companies may not be fully aware of the array of cost-savings opportunities and various abatements and exemptions available.

Action:

- A Multistate Tax Credit Review is designed to identify, quantify, and obtain the statutory tax credits for new investments and new jobs, grants for the training of employees, and various abatements and exemptions and other financial incentives that may be available to a company based on its particular circumstances.

Impact:

- Companies may be able to uncover significant opportunities to increase cash flow and reduce operating costs, and secure benefits needed to facilitate expansion, implement new technologies, enhance operational efficiencies or further other strategic business goals.

Transaction Cost Analysis (“TCA”) Study

Issue:

- Many transaction costs (i.e., costs associated with acquisitions, mergers, reorganizations...etc.) may require capitalization for financial reporting purposes.
- Many companies follow their financial reporting method and overlook the opportunity to identify deductible transaction costs especially if there is a "success-based" fee paid to an investment banker.
 - Companies may be capitalizing certain costs that can be currently deductible or amortized for tax purposes.

Action:

- A TCA study will investigate, properly categorize, and document a company's transaction costs so that these costs may be properly categorized for more effective tax treatment available under the law.

Impact:

- Companies may be able to recognize current tax savings, improve cash flow and meet contemporaneous documentation requirements.

Transaction Cost Analysis (“TCA”) Study (continued)

Other Considerations:

- A Transaction Costs Analysis consists of analyzing, categorizing, and properly documenting activities and expenses incurred in connection with exploring and entering into corporate transactions in order to recommend the proper federal income tax treatment of such cost.
- Final Regulations (December 2003) require taxpayers to capitalize costs that *facilitate* a transaction
- Tax treatment follows the activities performed by the service providers
- Success-based fees - Contemporaneous documentation requirement
- FAS 141(R) considerations:
 - Acquisition-related costs are no longer included as part of the purchase price.
 - Effective from the fiscal year beginning on or after December 15, 2008.

Canadian Indirect Tax Review

Identify recoverable overpayments of Canadian GST and sales tax

Identify system weaknesses otherwise leading to penalty assessments resulting from noncompliance with GST and sales tax rules

Other Benefits

Future savings through education;

Pro-active tax planning;

Reduction of potential interest and penalties by identifying exposures; and

Recovery of overpayments and duplicate payments.

VAT Cash Savings Opportunities

Indirect taxes, such as a Value Added Tax (VAT), could constitute significant additional costs

In Europe, sellers must typically charge VAT at a rate of around 20% of the net sales price.

In Asia, rates of indirect tax are generally lower, ranging from 5% to 15%

U.S. Multinational Corporations may incur VAT on employees travelling, professional services, intra-group charges, foreign-sourced fees on M&A, overseas distribution and freight costs, supply chain management, overseas warranty obligations, and other such activities abroad.

VAT Cash Savings Opportunities (continued)

VAT on imports - Various VAT deferment regimes available in certain countries

VAT due on the importation of goods in many countries is open to deferment, which may result in significant cash flow savings

Taxpayers moving goods for processing/testing may defer the payment of VAT as well.

VAT reporting rules in certain countries may allow a company to defer the payment up to two months

Cash Tax Optimization

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