

# NATURAL RESOURCES & THE R&D TAX CREDIT

Financing Innovation in the New Tax Regime

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# With You Today



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# Overview of Today's Discussion

## The R&D Tax Credit

- What is the R&D tax credit?
- Why is the R&D tax credit relevant to natural resources now?
- Qualifying activities in the natural resources industry

## Investing In The Future Of Natural Resources

- Outlook for research & development activity in the natural resources sector

## Additional Tax Updates & Considerations

- Tax reform's impact to natural resources
- Additional tax updates and considerations for the R&D credit

## Open Forum: Q&A



A low-angle photograph of large, white, curved industrial pipes against a clear blue sky. Yellow metal railings are visible on the right side of the frame. The image is partially covered by a semi-transparent white banner at the bottom.

# **R&D TAX CREDITS: HISTORY & OVERVIEW**

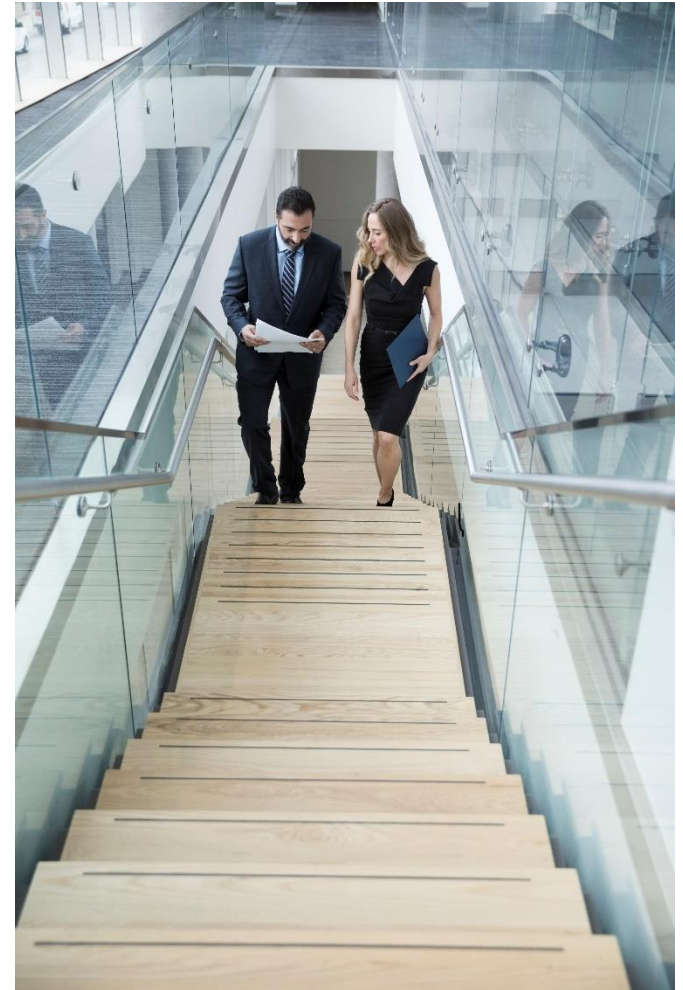
# What is the R&D Tax Credit?

## Overview of the R&D tax credit

- Established in 1981 to stimulate growth by providing incentives to companies that incur expenses engaging in research and development activities

## What are the core benefits of the R&D credit?

- Offset tax liabilities by up to 20% of qualified spending
- Credit can be used against income tax, effective tax rate and franchise tax
- Allows companies to increase cashflow and valuations
- Credit can be carried back 1 year or forward for up to 20 years



# Who Qualifies for the R&D Tax Credit?

If your company is trying to make products, processes or software  
**better, faster, leaner or greener,**  
you are likely eligible for the R&D tax credit.

## Debunking common R&D misconceptions:

- **Myth 1:** R&D credits are awarded only for *successful* attempts to make improvements.
- **Myth 2:** My company isn't using any *groundbreaking or transformative technology*, so we must not be eligible for the credit.
- **Myth 3:** The process to qualify for R&D credits is arduous and requires *excessive documentation*.



# R&D TAX CREDITS FOR NATURAL RESOURCES

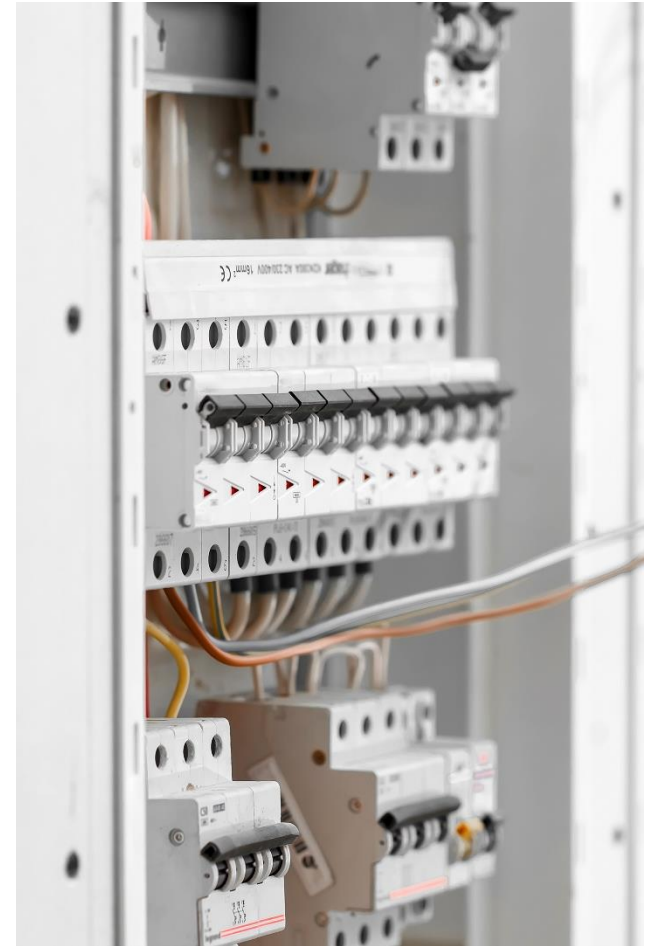
## *WHY NOW?*

# History of the R&D Credit in Natural Resources

- Most natural resources companies conduct activities that qualify for the credit
- Historically, R&D tax credit claims in the sector have been low

## Comparing levels of R&D credits across industries in 2013:

- Natural Resources: \$300 million in R&D benefits
  - Mining: \$78 million
  - Utilities: \$69 million
- Manufacturing & Distribution : \$6.8 billion
  - More than **22 times** the value of credits claimed in natural resources





# History of the R&D Credit in Natural Resources

## Why hasn't the R&D tax credit been heavily used in natural resources?

- Many natural resources companies paid the corporate alternative minimum tax (AMT), which the R&D tax credit cannot offset

## Why did natural resources pay AMT instead of income tax?

- All companies need to calculate their tax liabilities under AMT and income tax and then pay the higher of the two
- Natural resources companies are eligible for the percentage depletion deduction to recover intangible drilling costs (IDCs), or capital expenditures incurred developing wells
- Companies often had higher tax liabilities under AMT because the IRS requires depletion deductions to be added back to determine AMT

# Tax Reform and the R&D Tax Credit

Tax reform impacted tax planning and increased the value of the R&D Tax

## Elimination of the AMT

- U.S. mining, oil & gas and other natural resources companies that often pay AMT may now be paying regular income tax

## Net operating losses (NOLs) deduction limitation

- NOLs generated for tax years beginning after Dec. 31, 2017 may offset only up to 80 percent of income and may no longer be carried back
- Companies may now owe income tax

## Reduction in the corporate tax rate

- The top corporate rate was reduced from 35% to 21%
- Effectively increases the R&D credit's net benefit by more than 21%, from 65% to 79%





# QUALIFYING RESEARCH ACTIVITIES

# Qualifying Activities: The Four-Part Test

To qualify for the R&D credit, activities should pass the four-part test:

**1** Qualified Purpose

**3** Process of Experimentation

**2** Technological Uncertainty

**4** Technological in Nature

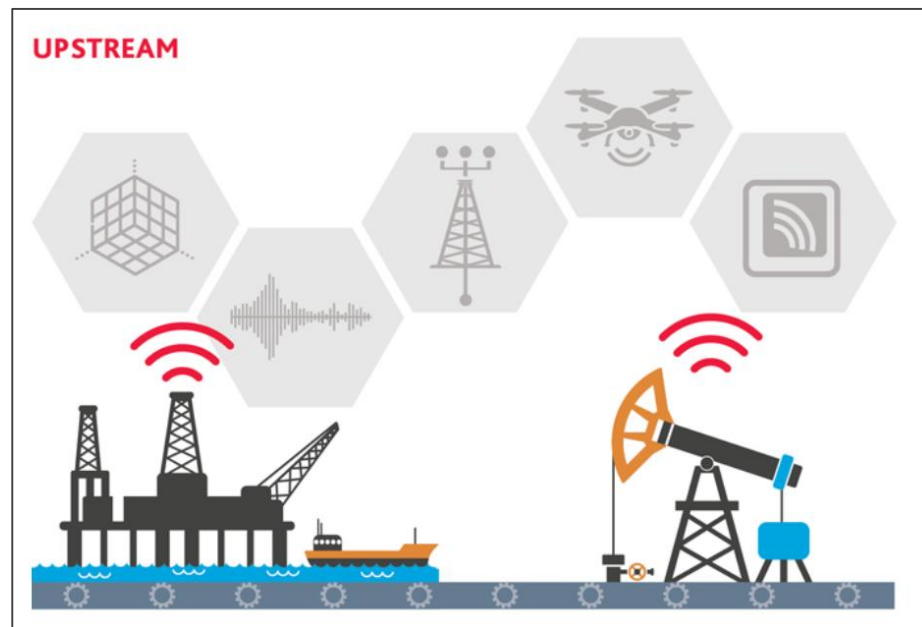


# Oil & Gas: Qualifying Activities

## Upstream (Exploration & Production)

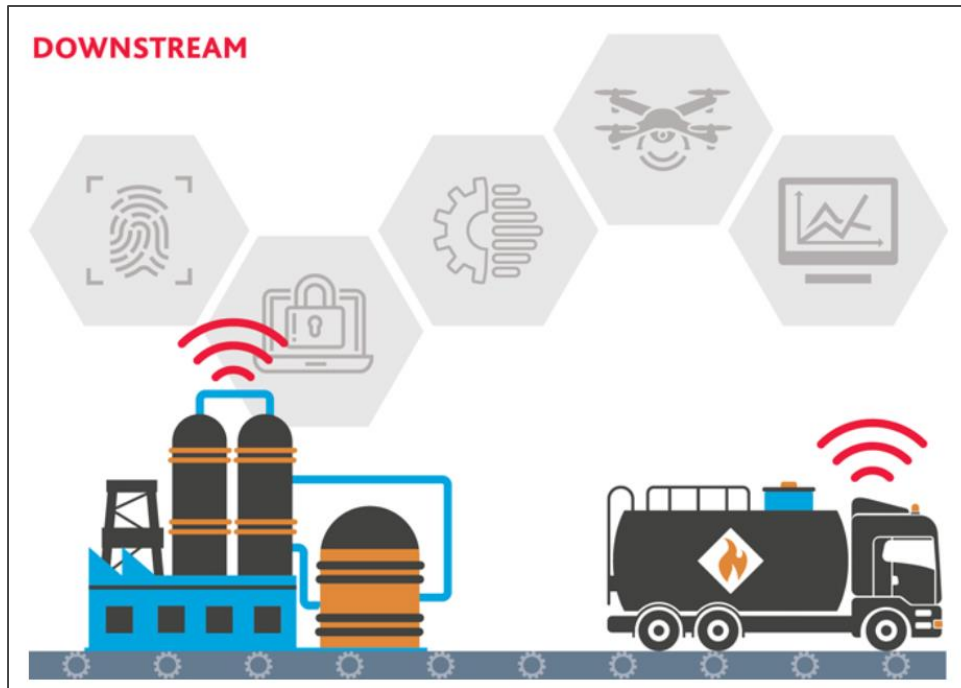
Qualifying activities may include:

- Updates to seismic imaging technology and Monte Carlo simulations
- Drilling techniques
  - Drilling mud systems
  - Directional drilling
  - Refracking wells
  - Disposal methods
- Environmental testing and remediation



# Oil & Gas: Qualifying Activities

## Downstream



### Qualifying activities may include:

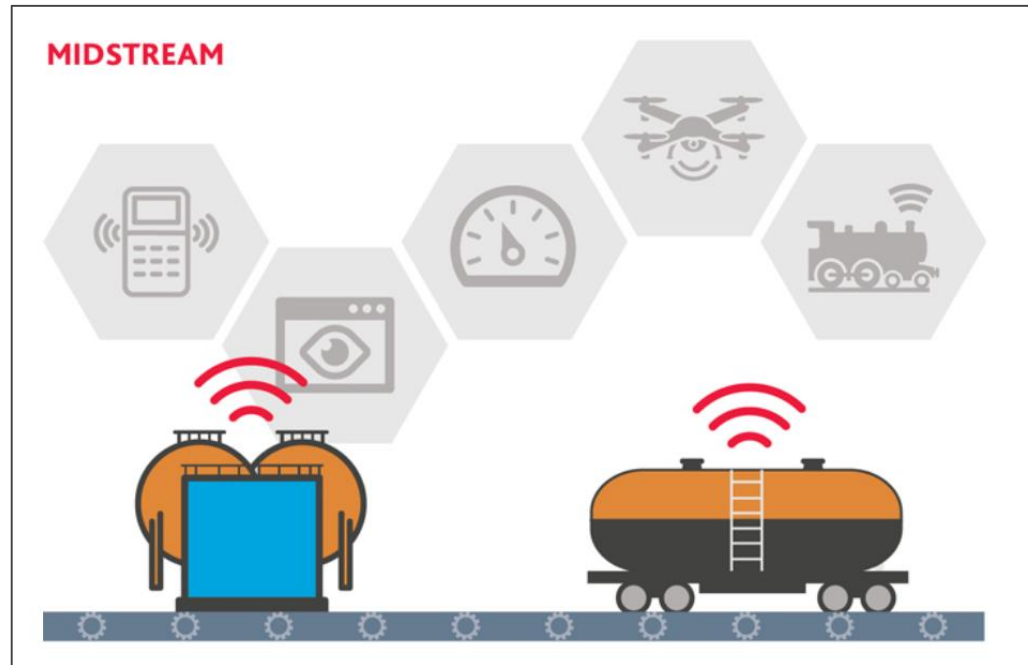
- Chemical reaction process development
- Distillation and separation
- Improved refining and purifying processes
- Updates to safety monitoring features

# Oil & Gas: Qualifying Activities

## Midstream

### Qualifying activities may include:

- Structural changes to improve the design of a pipeline
- Enhancements to oil and gas storage facilities
- Improved monitoring of oil and gas during transportation
- Environmental testing and remediation



# Mining: Qualifying Activities

Generally, anything related to designing, engineering, or implementing equipment or processes that try to optimize or improve production processes, including:

## Metallurgical Processes

- Increasing quality and quantity of production from the metallurgical process
- Making improvements to one phase (e.g. smelting) without slowing or shutting down others (e.g. concentrating & refining)

## Mining

- Mine-development alternatives
- Developing new and improved leachates
- Dewatering alternatives
- Advancements in new mining techniques, like deep-sea mining



# Qualified Research Expenses (QREs)

## What expenses qualify?

### Qualified research expenses include:

- *Taxable wages* for employees who perform, directly supervise or support qualified activities
- *Cost of supplies*, including extraordinary utilities, excluding capital items or general administrative supplies
- *65%-100% of contract research expenses*, provided the taxpayer:
  - Retains substantial rights to the activity's results
  - Pays the contractor whether it succeeds or fails
- *Rental or lease costs of computers* used in qualified activities:
  - Example: Payments to cloud service providers (CSPs) for the cost of renting server space to develop or improve a component



**INVESTING IN THE FUTURE**

# History of R&D in Natural Resources



U.S. shale revolution: hydraulic fracturing as a product of R&D



Oil & gas companies have in the past been labelled “low R&D intensity,” investing less than 1% of net revenue in R&D



R&D spending is starting to increase



Investing in innovation is the first step towards global oil & gas companies reducing expenditures while maximizing production

# Investing in the Future

Ready or not, the industry must contend with an ever-changing 'normal'

The successful natural resources company of the future will be a lean machine and determine how to:

- Cut costs and maximize production
- Enhance operational efficiencies

*By 2020, BDO predicts...*



Most of the R&D spending in the energy industry will go toward technologies that enhance E&P efficiencies



The average E&P company will make use of 10% of its Big Data



# The Future will be Powered by Lean Machines

Natural resources is embracing automation, but further digitization could lead to significant savings.

- 30% of new U.S. onshore wells use remote operations, about double 2016 rates
- IEA: Digital technologies can cut oil production costs by 10-20%

## Is the commoditization of data in our future?

- The average offshore rig has 30,000 data-generating sensors
- Less than 1% of that data is analyzed
- Oilfield services companies are investing in data analytics to tap into and commoditize oil & gas data



# ADDITIONAL R&D TAX UPDATES & CONSIDERATIONS

# Additional Updates to the R&D Tax Credit

## The Protecting Americans from Tax Hikes Act (PATH Act)

- Extended the credit, which had expired in 2014
- Makes the R&D credits permanent
- Effective for taxable years beginning after Dec. 31, 2015

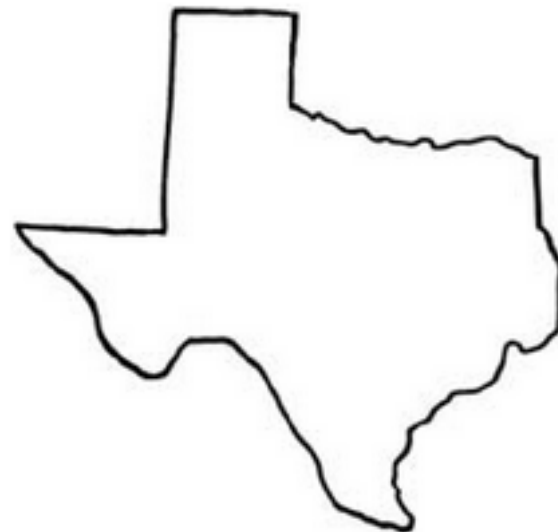
## Large Business & International (LB&I) Directive

- Intended to relieve the administrative burden
- LB&I examiners are directed to accept QREs per Adjusted ASC 730 Financial Statement R&D

# State-specific R&D Tax Considerations

## Spotlight on Texas

- Companies can use the R&D tax credit to offset regular income tax and their effective tax rate
- Companies based in Texas and other states that don't collect income tax can still benefit from the credit
- The R&D tax credit can be used to offset the franchise tax
- Companies may also qualify for sales and use tax exemption on the purchase, lease, rental, storage or use of depreciable tangible personal property directly used in qualified research







In the U.S. and more than **35 countries** around the world, tax laws favor **THE PURSUIT OF INNOVATION**



# International R&D Tax Incentives

## Incentives offered in Canada

### Scientific Research and Experimental Development (SR&ED) program

- Incentivizes innovation
- Natural resources companies that pay tax in Canada may be eligible
- Highly leveraged by the clean energy sector

For more information about SR&ED and other Canadian tax incentives, contact:



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A photograph of two men in business suits and hard hats walking past the large, dark hull of a ship. The man on the left is wearing a blue hard hat and holding a rolled-up document. The man on the right is wearing a red hard hat and holding a folder. The ship's hull is black with several portholes and a large, rusted metal structure protruding from it. The background is a clear blue sky.

**CONSIDER YOUR TOTAL TAX LIABILITY**

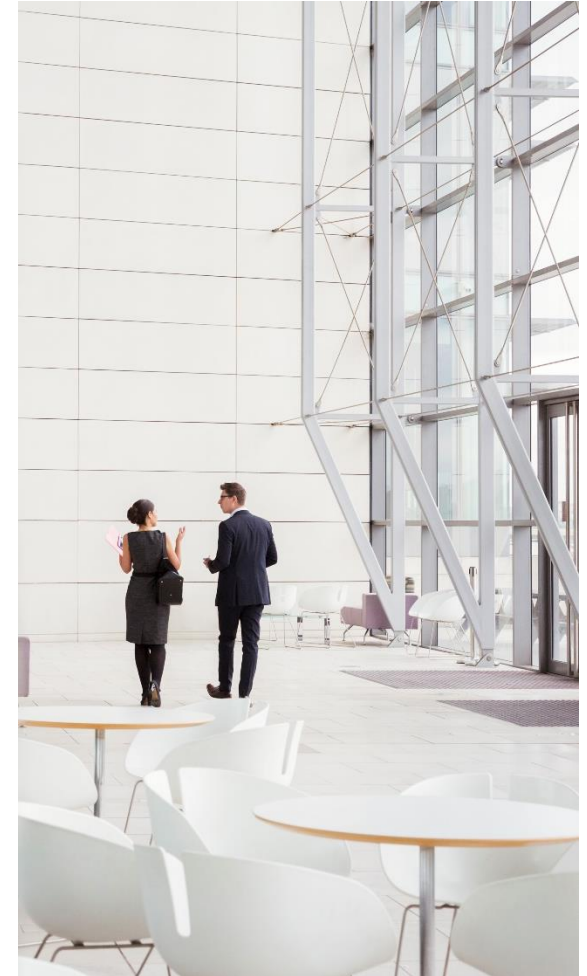
# Tax Reform Recap for Natural Resources

## Tax reform changes covered in this webinar

- Elimination of corporate AMT
- Net operating losses (NOLs) deduction limitation
- Reduction in the corporate tax rate

## Additional tax changes


- Reduction in the pass-through rate
  - Raises deduction available to pass-through filers to 20%
- Exploration & production/transition tax on U.S. shareholders
- Elimination of Section 199 domestic production activities deduction (DPAD)
  - Historically, provided companies with up to an additional 9% tax rate benefit on qualified domestic production income





# Calculate Your Total Tax Liability

BDO offers resources to help companies assess their total tax liability



## BDO Knows: Tax Reform

### Tax Reform Decoder: What do the changes to U.S. tax code mean for you?

There are still many unknown tax reform impacts. Companies should assess what they've learned, understand how the new law will impact their business strategy, and look ahead to what's next. Let us help you decode what the new tax code means for your business.

Answer the questions below to receive a **customized assessment of what your company should consider in order to optimize tax strategy and minimize total tax liability**, along with helpful resources to help you chart your path to success.

### Tax Reform Assessment

**1. Does your business operate internationally?**

☐ Yes

☐ No



**QUESTIONS?**



# SPEAKER BIOGRAPHIES



# Biography



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Clark is the Tax Managing Principal for BDO's Houston office and National Practice Leader in [BDO's Natural Resources practice](#). Clark has more than 20 years of corporate tax experience in both public accounting and industry and has extensive experience serving clients in the natural resources industry, specifically [oil and gas](#).

He has worked on hundreds of oil and gas transactions and has led over 50 different engagements for upstream, midstream, and downstream oil and gas clients including master limited partnerships (MLPs) and oilfield services companies. His broad experience includes ASC 740, international as well as U.S. federal and state tax planning, transfer pricing, and internal reorganizations.



# Biography



## David Wong

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David Wong is a Partner with BDO's Specialized Tax Services practice and leads both the West Region and Southwest Region R&D tax services practices. He specializes in R&D tax credits and the Foreign Derived Intangible Income ("FDII") Deduction.

David has more than 14 years of professional experience, including many years in the R&D Tax Credit practice at a Big Four firm. He has experience helping both large and small oil & gas companies identify and document their R&D credits, as well as assisting them in defending those credits upon Internal Revenue Service (IRS) and state taxing authority exams.

He has experience with taxation issues in Texas, Washington, New Mexico, Utah, California, Arizona, Oregon, and Idaho and has worked with companies ranging from the development stage to those with over \$20 billion in revenues. During his career, David has identified and defended over \$1 billion of R&D tax credit claims.

# Biography



## **Gabe Rubio**

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Gabe is a managing director in BDO's R&D Tax Services Practice and is based in our Los Angeles office.

Gabe has over six years of professional experience focused on R&D tax services. His experience includes helping both large and small companies identify and document their R&D credits as well as assisting them in defending those credits upon IRS and/or state taxing authority exams.

He has experience with the following states: California, Oregon, Idaho, Colorado, Utah, New Jersey, Georgia, and Arizona. During his career, Gabe has worked to identify and defend R&D tax credit claims in a broad range of industries, including: Natural Resources, Aerospace, Manufacturing, Consumer Products, Pharmaceuticals and Professional Services.

# Biography



**Matthew Ferreira**  
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Matt is a Senior Manager in BDO's R&D Tax Services Practice and is based in the Dallas office.

Matt's career at BDO started in corporate tax before transferring to Specialized Tax Services (STS), where he has spent the remainder of his career. His experience includes helping both large and small companies identify and document their R&D credits as well as assisting them in defending those credits upon IRS and/or state taxing authority exams.

He has experience with the following states: Texas, Arkansas, Louisiana, New Mexico, Colorado, California, Oregon, Illinois, Utah, New Jersey, Georgia, Wisconsin, and Arizona. During his career, Matt has worked to identify and defend R&D tax credit claims in a broad range of industries, including natural resources/oil & gas, manufacturing and construction/building products.

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