INTERNAL MEMORANDUM

TO: BGI Sales

CC: Serge De Blois, CEO

FROM: Todd Sutherland, J.D., LL.M. in Taxation, Vice President of Operations

SUBJECT: Impact of Prototype Regulations (T.D. 9680) on the Steel Industry

DATE: June 10, 2015

Background:

Prior to July 2014, the IRS stood firm behind the "depreciable property rule", where expenditures for the acquisition or improvement of property subject to an allowance for depreciation or depletion are ***not deductible*** under Section 174 (and therefore, not allowed under the Section 41 Credit for Increasing Research Activity).

Regulatory Development:

However, this all changed when the IRS and Treasuring issued final regulations on July 17, 2014 with regard to the Section 174 deduction for research and experimentation (R&E) expenditures (T.D. 9680), providing:

1. that if expenditures qualify as R&E, a subsequent event cannot change entitlement to the deduction, and *hence it is irrelevant whether a product resulting from qualifying expenditures ultimately is sold or used in the taxpayer's trade or business*;
2. provided that the 'depreciable property rule' in Reg. sec. 1.174-2(b)(4) is an application to depreciable property of the general definition of R&E expenditures in Reg. sec. 1.174-2(a)(1);
3. defined the term "pilot model" (as used in sec. 1.174-2(a)(2)) as any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product, including a fully

functional representation or model of the product or a component of a product (to the extent the new 'shrinking-back' provision applies);

4. clarified that testing to eliminate design uncertainty (e.g., testing whether certain features can be integrated into a design) qualify as R&E expenses.

The Takeaway:

The final regulations will have a taxpayer-favorable impact beyond Section 174 or tangible property manufacturing.

The final regulations clarify that efforts to eliminate design uncertainty can qualify under Section 174, even when the new product is a variant of a previous product class, so long as the taxpayer's previous product information did not resolve the uncertainty associated with the subsequent product design. Because the technical uncertainty standard under Section 174 also applies to Section 41 research credit efforts, taxpayers may have additional research tax credit opportunities associated with efforts to develop improved product variants.

Another helpful provision states that if expenditures qualify as R&E, it is irrelevant whether a resulting product ultimately is sold or used in the taxpayer's trade or business. This provision makes clear that subsequent events cannot reverse entitlement to the Section 174 deduction (and the Section 41 credit). These clarifications should assist taxpayers undergoing examination if the IRS continues to take the government's position in T.G. Missouri (that if a prototype is sold by the taxpayer, the cost of that prototype is ineligible to be a Section 174 expense and therefore not a qualified research expenditure for purposes of the Section 41 credit).

The provision allowing taxpayers to apply the final regulations to years open for assessment could be helpful for taxpayers that might not have claimed certain deductions on prior returns or are currently undergoing examination. Taxpayers that have not followed these regulations may be able to take a fresh look and claim additional expenditures, particularly if the sale of a prototype or its use as a demonstration model was at issue. The IRS now should be accepting those taxpayer positions.

Impact on Steel Industry:

The new prototype regulations have resulted in significant increases to Section 41 claims of BGI steel clients. The area of opportunity most frequently relates to the production of "first articles". A secondary opportunity relates to the installation of a new or improved production line that is considered a prototype line.

Furthermore, the IRS has broadly approved BGI's approach to substantiation of such. Over the past year, BGI has worked closely with IRS in examination of our client's prototype activities and expenditures and the method to substantiate such costs for filing purposes. The benefit related to including such prototype costs has resulted significant increases of certain companies historical R&D claims. A client case summary is provided below.

Timing Alert:

As noted above, the application of these regulations may be retroactively applied. The window to take a fresh look at this opportunity for certain open tax years may be closing. Therefore, BGI recommends that this opportunity be presented to our clients and prospects in the steel industry immediately.

Case Summary:

Braithwaite Global
RE: Impact of the Addition of Expenses related to Prototype Component Parts
Industry: Steel
Case Study Memo

CLIENT	CALC. METHOD	QREs without Prototype Component Costs	QREs WITH Prototype Component Costs	% Increase	IRS Approved
Client #1 - Steel Processor	ASC	$ 1,700,000	$ 2,250,000	76%	YES
Client #2 - Metal Manufacturer (Carbon, Aluminum, Stainless)	ASC	$ 2,300,000	$ 4,100,000	56%	YES
Client #3 - Metal Manufacturer (Carbon Alloy, Aluminum, Stainless)	ASC	$ 575,000	$ 926,000	62%	TBD
Client #4 - Manufacturer of High Quality Steel Tubulars	ASC	$ 872,000	$ 1,330,000	66%	TBD