Federal tax credits and incentives that make an impact

2017 Engineering and Construction Conference
Federal tax considerations + credits & incentives

Agenda

**Topic**
- Research & development tax credit
- Section 199 — Qualified production activities
- Energy sustainability initiatives
- Tax equity investing
- New markets tax credits
Gateways to credit and incentive opportunities

- Processing
- Provides valuable data

Additional tax benefits
- Multistate
- Federal
- International

Other credits and incentives
- Investment credits
- R&D credits
- Training grants or credits
- Federal credits
- Negotiated incentives

State hiring credits
- Several states offer tax credits similar to WOTC

WOTC
- State hiring credits
- Other credits and incentives

Other credits and incentives
- Additional tax benefits
IRC Section 41
Research & development tax incentives
Research and development tax credit overview

- Research credits are generally non-refundable, but can be carried back 1 year and forward 20 years (for taxable years after 1997)

- General business credit limitations apply, i.e., credit generally limited to the difference between regular tax and the tentative minimum tax

- Research credit benefits available offset alternative minimum tax for eligible small businesses – less than $50 million in average gross receipts for the three preceding years

- Congress permanently extended R&D credit retroactively as of January 1, 2015

- Opportunities to claim:
  - IRC Section 41 credit
  - **IRC Section 174 deduction**
  - State research credits
  - Global incentives
R&D tax credit qualification criteria: 4-Part Test

• **Permitted Purpose**
  - New or improved product or process
    ◦ Function
    ◦ Performance
    ◦ Reliability
    ◦ Quality

• **Elimination of Uncertainty**
  - Capability
  - Method
  - Appropriateness of design

• **Technological in Nature**
  - Fundamentally rely on principles of
    ◦ Physical science
    ◦ Biological science
    ◦ Computer science
    ◦ Engineering

• **Process of Experimentation**
  - Evaluation of alternatives
  - Modeling
  - Testing
  - Refining or discarding hypotheses

Internal-use software needs to meet additional three criteria
R&D tax credit — Recent developments

- New Internal-Use Software (IUS) Regulations
  - Provides a clearer definition of software developed for internal-use
  - New regulatory definition is intended to target the back-office functions of a taxpayer that most taxpayers would have regardless of the taxpayer's industry (i.e. inventory management, financial reporting, payroll, etc.)
  - Creates significant opportunities in the FSI, Retail, Travel/Administrative Services, and any other companies investing in major software development efforts

- Prototype Costs — New Section 174 Regulations
  - Significant opportunity that most companies are not fully applying to prototypes, customized equipment/tooling, and manufacturing trail runs
  - Pilot Models: A "pilot model" is 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. The term includes a fully-functional representation or model of the product or a component of a product.

- Recent Case Law Impacting Contract Analysis – Geosyntec and Dynetics
R&D tax credit
Current IRS exam environment & defense strategy

Research and Development Tax Credit
Current IRS Exam Environment & Defense Strategy

• IRS is resource constrained
  – Fewer statistical samples
  – Fewer MITRE audits
  – Fewer IRS Engineers assigned to audits
• Penalties — less frequently asserted
• Appeals procedures — push for teleconferences over in-person conferences
• How to best defend a research credit
  – Begins with how the information is compiled; anticipate the issues
  – Kickoff meeting or discussion with exam personnel
    ◦ Discuss the process
    ◦ Listen to examiners questions/concerns
    ◦ Manage the issuance of IDRs and due dates
    ◦ Ensure the record reflects the facts necessary to position you well for the appeals process
Section 199
Qualified production activities deduction
Section 199: Technical topics for E&C

**Special Situations:**
- Shrink-back analysis (hot topic, §1.199-3(d)(1))
- Government contractors
- EAG: attribution of activities
- Flow-through entities (with wage issues and JV activities)
- Intercompany transactions
- Prior Period Expenses
- Gain related to Asset Transactions:
  - Sale of Inventory — i.e. the sale of WIP goods or finished goods
  - Sale of Real Property — i.e. the sale of retail buildings or manufacturing facilities
  - Sale of Tangible Personal Property — i.e. the sale of equipment
  - Sale of Software — i.e. the sale of software used in the Company’s business
  - Sale of Partnership Interests — provided it is treated as a sale of assets under §751(a) or (b) and those assets were manufactured by the taxpayer
Section 199: IRS audit issues

**IRS Qualification Activity:**

- Contract review by project / Item by Item analysis
- Scope and Location of the project
- Review Customer Agreements
- Project manager discussions
- Repair vs. Substantial Renovation
- Identifying non-qualifying services
- Determining available financial data and reconciliation of G/L to job cost reports
- DPGR amounts compared to the consolidated tax return
IRS Quantification Activity:

- 861 expense apportionment
  - Must be consistent with the foreign tax credit calculation
    - The methods utilized to apportion SG&A expenses within the Section 199 calculation must be the same methods utilized for to allocate expenses with the Foreign Tax Credit Calculation

- Research and experimental expenditures
  - Definitely related and allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to a taxpayer’s product category (or categories) (see § 1.861-17)

- Production Asset Ratio Calculation
  - A reasonable production asset ratio calculation must be performed to apportion interest expense
Section 199: IRS audit issues (cont.)

**IRS Challenges with Software Activity:**

- Properly identifying revenues associated with use of the software
- Third-party use of the software
- Software as Service (SAS model)
  - IRS position that taxpayers are providing a service not software

**Construction Litigation Guidance:**

179D Deduction

Energy & sustainability incentives
A federal tax deduction ranging from $0.30/sf to $1.80/sf for newly constructed or renovated facilities with energy efficient commercial building property placed in service from 2006 – 2016.
### EPAct of 2005 — Interim and permanent rules

#### Commercial building tax deduction — IRC 179D
- Building must be placed in service 2006 – 2016
- Be located within the US
- Based on ASHRAE 90.1-2001 up to 2015 / ASHRAE 2007 for 2016

<table>
<thead>
<tr>
<th>The Interim Lighting Rule</th>
<th>The Permanent Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lighting System</td>
<td>HVAC/hot water Lighting Building Envelope</td>
</tr>
<tr>
<td>$0.30 - $ 0.60/sf</td>
<td>$ 0.60/sf $ 0.60/sf</td>
</tr>
</tbody>
</table>

- Based on Lighting Power Density (LPD)
- Sliding scale deduction:
  - 25% - 40% LPD reduction compared to ASHRAE 90.1-2001
  - 50% LPD reduction for warehouses
- Must meet certain wiring/control requirements
- Qualified Individual certification
- Interior lighting systems only
- Simple calculation

- Maximum deduction of $1.80/SF or $0.60/SF for each system
- Minimum energy savings must be achieved
- Qualified Individual certification
- Must use qualified energy software to calculate energy savings

#### Public Buildings
Designers of public buildings may receive an allocation of the deduction from the owner
- Allocation can be shared among multiple designers
- Non-profits buildings are not eligible
Benefits to owners, builders and designers

Eligible Parties

- Owners of energy efficient commercial building property
- Designers of government properties

<table>
<thead>
<tr>
<th>For a 100,000 SF Building</th>
<th>Interim Rule</th>
<th>Permanent Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum deduction per square foot</td>
<td>$0.60/SF</td>
<td>$1.80/SF</td>
</tr>
<tr>
<td>Maximum deduction</td>
<td>$60,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>First year tax savings</td>
<td>$21,000</td>
<td>$63,000</td>
</tr>
</tbody>
</table>

**For Owners (1)**

- Net present value (NPV) | $12,300 | $37,000 |

**For Builders and Designers (1)(2)**

- Net present value (NPV) | $21,000 | $63,000 |

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(1) NPV based on 35 percent tax rate and 6 percent discount rate.
(2) For builders and designers the first year deduction is “permanent” and is not offset by depreciation of capital improvements.
Public buildings — Additional considerations
Designers of governmental buildings are eligible

- **Who is the Designer?**
  - The party who creates the technical specifications for installation of energy efficient commercial building property
  - Similarly, a design-build contractor responsible for the design of a facility is also eligible
- **What if there is more than one designer?**
  - The owner of the building shall:
    - Determine responsible designer and allocate the full deduction
    - Allocate the deduction among several designers
- **Who can request the allocation?**
  - Many governmental agencies require the prime contractor to request the allocation
Public buildings — Additional considerations (cont.)
Designers of governmental buildings are eligible

• **How does the designer receive the deduction?**
  
  – Designer must receive approval in writing for the allocation from the owner of the building
  
  – Recommendation - designer obtain a signed Letter of Commitment from the owner prior to the study

• **What buildings qualify?**
  
  – Property owned by a Federal, State or local government or a political subdivision thereof
  
  – Non for profits do not qualify
Case study – Designer benefit
Government Office Building

• Public Facility
• In Service: June 2016
• Size: 500,000 sf
• LEED Gold
• Assumed Tax Rate: 35%

• Qualifying Systems:
  • Lighting - $0.60/sf
  • Building Envelope - $0.60/sf
  • HVAC/Hot water system - $0.60/sf

Total Deduction: $900,000
Tax Benefit to Designer: $315,000
Tax credit investing
Tax credit investing background

• While some federal investment tax credits are easily utilized directly by a taxpayer, others are typically larger credits that a taxpayer cannot use effectively.

• Tax credit equity investors are typically required for the following projects:
  – Renewable Energy
  – Low Income Housing
  – Historic Building Rehabilitation

• Tax equity investors make capital investments in projects in order to receive tax and other financial benefits of the investment in the underlying asset.

• Traditionally, large financial institutions have been the only tax equity investors, but in recent years other large corporations have begun to invest.
### Characteristics of different tax credit investments

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<tr>
<th>Tax Credit</th>
<th>After-Tax IRR</th>
<th>Investment Horizon</th>
<th>Timing of Benefits</th>
<th>Transaction Structures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low-Income Housing Credit (IRC § 42)</td>
<td>5% - 7.5%</td>
<td>15 Years</td>
<td>Tax credit - 10 years Depreciation - 27.5 year S/L</td>
<td>Limited Partnership</td>
</tr>
<tr>
<td>Historic Rehabilitation Credit (IRC § 47)</td>
<td>10% - 20%+</td>
<td>5 Years</td>
<td>Tax credit - 1st year Depreciation - 39 year S/L</td>
<td>Lease Pass-Through</td>
</tr>
<tr>
<td>Production Tax Credit (IRC § 45)</td>
<td>7.5% - 9% (Unlevered) 12% - 15% (Levered)</td>
<td>10 Years</td>
<td>Tax credit - 10 years Depreciation - 5 year MACRS</td>
<td>Partnership Flip</td>
</tr>
<tr>
<td>Energy Credit (IRC § 48)</td>
<td>7.5% - 9% (Unlevered) 12% - 18% (Levered)</td>
<td>5-8 Years</td>
<td>Tax credit - 1st year Depreciation - 5 year MACRS</td>
<td>Partnership Flip Sale / Leaseback Lease Pass-Through</td>
</tr>
<tr>
<td>New Markets Tax Credit (IRC § 45D)</td>
<td>5% - 7%</td>
<td>7 Years</td>
<td>Tax credit - 7 years</td>
<td>Leveraged Investment Fund</td>
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(1) NPV based on 35 percent tax rate and 6 percent discount rate.

(2) For builders and designers the first year deduction is “permanent” and is not offset by depreciation of capital improvements.
New markets tax credit
NMTC program overview

Origin and Purpose of the New Markets Tax Credit (NMTC) Program

• Origin: Community Renewal Tax Relief Act of 2000
• Purpose: Stimulate investment and economic growth in low-income urban and rural communities

Potential Benefits of NMTCs

• Cash Benefit: Qualifying projects receive **upfront cash** (not tax credits) in the form of a low-rate, interest-only loan for 7 years.
• Typically, the loan is “forgiven” (i.e. purchased for a nominal amount of $1,000) at the end of the 7 year term.
• Subsidy (“forgivable” loan) amount of ~$2.5 million for every $10 million of capital expenditures, with limits.

How NMTCs are Used

• Loan Proceeds are typically used for real estate development, equipment, or working capital
• Financing Amount generally ranges between $7 million and $15 million per Community Development Entity (CDE)
  – Multiple CDEs may combine to provide more financing to a single project.
  – Smaller loans are available (i.e. under $2 million) with pre-packaged capital
• Significant job creation or delivery of social services make projects more likely to receive funding.
NMTC program overview
How it works

HOW IT WORKS
− **CDFI Fund** (part of Treasury) allocates NMTC authority to registered Community Development Entities ("CDEs") through a competitive application process. These third party intermediaries then look to investors and potential projects for investments into qualifying low income communities.

− **Tax Credit Investors** make cash investments in CDEs in exchange for the tax credits. The Tax Credit Investor receives more back in tax credits than it puts into the transaction, making them willing to walk away from the loan into the project at the end of a seven-year period.

− **CDEs** use Tax Credit Investor cash and other funds (e.g. market-rate loans or project sponsor funds) to make loans to the project. The tax credit equity portion is typically “forgiven” at the end of 7 years, providing the economic value to the project. Receive fee and services income for the use of allocation.
NMTC qualifying businesses

**NMTC Businesses can operate in many industries, including:**

- Commercial and Industrial Real Estate
- Manufacturing Facilities (e.g. new construction, expansion, or equipment purchases)
- Business Loans (e.g. asset purchases or working capital)
- Residential Rental / Commercial Mixed-Use Real Estate
- Renewable energy development (e.g. solar panels or wind turbines)
- Health Care Facilities (hospitals, FQHCs)
- Community Facilities (e.g. charter schools, job training, museums, public-benefit facilities)
NMTC economic summary

How it works:

− Cash Benefit to Qualifying Projects: Only $7.7 million cash needed for a $10 million capital investment if the location of the development is in a low income community.

− A portion of the development costs is provided in the form of a loan from a Tax Credit Equity Investor.

− The Tax Credit Equity Investor receives more back in tax credits than it puts into the transaction, making them willing to walk away from the loan into the project at the end of a seven-year period.

− Capital expenditures that exceed $10 million can be eligible for increased benefit.

Benefit summary

Closing:

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Total interest expense:

$ (555,000) - Annual Asset Management fees and audit/tax preparation for investment entities paid through interest expense

Exit:

|$ (1,000) - put price to purchase B Note | |
| (984,900) - deferred 35% tax on B Note COD income | |
| $ (985,900) | |

Economic benefit:

|$ 1,873,387 Pre-Tax NPV Cash Flow over 7 Years at 6% discount | |
|$ 1,516,694 After-Tax NPV benefit at 6% discount rate | |
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