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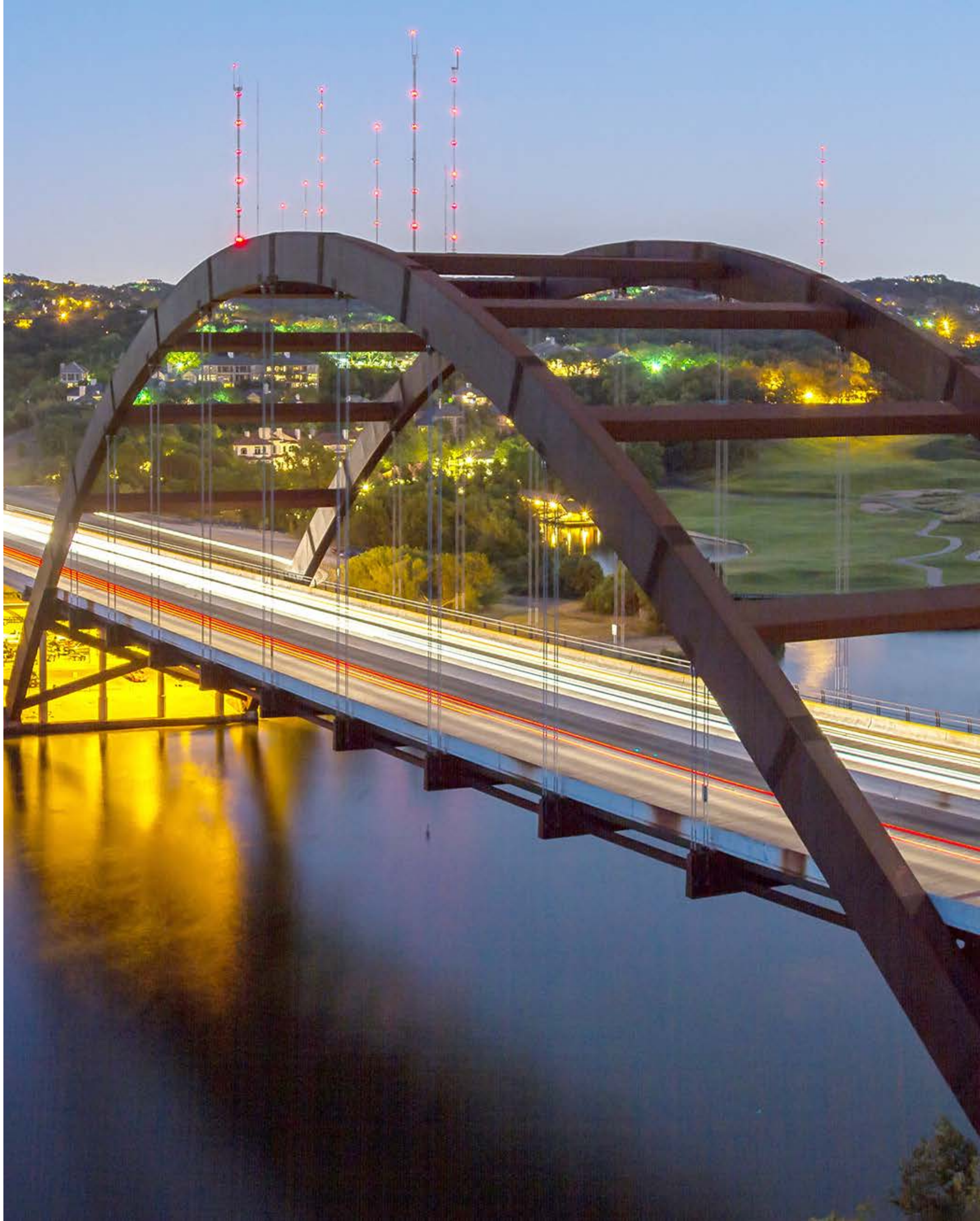
2016 Engineering & Construction Conference

June 15–17, 2016
The Westin Austin Downtown
Austin, Texas



Capturing Federal & State Tax Efficiencies

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8:30 – 10:00 a.m.

Contents

State Nexus Considerations

State Nexus Considerations

Public Law 86-272 does not apply to service providers

Physical presence in a state creates nexus. Consider the following:

- Traveling employees and partners/principals/officers
  - Impact to entity different from impact to employees
  - Impact to partners
- Telecommuters
- Projects in state
- Clients in state
- Governmental client

State Tax Nexus Issues

Economic Presence

- Sales in a state without having physical presence can create nexus
- Growing trend among states to assert nexus based on existence of a certain amount of sales to customers in the state (i.e., factor-based nexus)

Examples of states with bright-line factor-based nexus tests:

Alabama - California - Colorado - Connecticut

New York State (2015) -- Ohio (CAT)

Tennessee (2016) - Virginia - Washington (B&O Tax)

Multistate Commission Standard

Nexus created if during the tax period business exceeds $50,000 of property, $50,000 of payroll, $500,000 of sales, or 25% of total property, total payroll, or total sales

State Apportionment

State Apportionment
General Formula

Formula

- Used to determine portion of business's income attributable to activities within the state

Three Common Ratios

- Property
- Payroll
- Sales

Current Trend

- Extra weighting of the sales factor (TN moved from double to triple weighted sales factor in 2015)
- Single Sales Factor (Delaware phases in single sales factor for Corporate Income Tax)

State Apportionment

Sales Factor Rules – Sales of Other Than Tangible Personal Property

Cost of performance approach

- Greater cost
- Greatest cost
- Pro rata cost
- Third party costs
- Indirect costs
- Determination of separate income-producing activities

Market-based approach

- Benefits received
- Commercial domicile of client
- Billing address of client

States are more heavily weighting sales factor, including moving to 100% sales, States with equal three factor weight formulas continue to diminish.

Cost of performance rules and the interpretation of those rules vary by state in the following areas: Third Party Cost, Indirect Cost, Determination of separate income-producing activities

Perceived limitations of income producing activity rule: Does Not Measure Location of Customer Base, May Duplicate Property and Payroll Factors, Hard for State Auditors to Determine, Tends to Overweight the Sales Factor For Service Providers Operating in a State

Trend: Market-based Sourcing

States are also moving toward market-based sourcing rules and away from cost of performance sourcing rules for services

- Market-based sourcing arguably serves the purpose of the sales factor by more accurately reflecting the customer base for taxpayer’s services
- Cost of performance tends to overweight the sales factor for service providers operating in state, which could dissuade service providers from considering in-state investment

Sales Factor Sourcing

What is Market?

Complex services — Where is the “benefit received,” “service received,” “service delivered,” or “customer located?”

- Tests are hard to apply
- Where order is taken?
- Terms of the contract?
- Client’s customers?
- Client’s commercial domicile?

Data gathering

- Systems issues/limitations
- Electronic Billing
- Billing Centers
- “Garbage in, Garbage out”

Market-Based Sales Sourcing

States Recently Changing to Market-Based Sourcing Rules

- Currently nearly two dozen states have adopted market-based sourcing rules for sales other than of tangible personal property. States that have recently transitioned to market-based rules include:
  - Arizona (elective phase-in 2014-2017)
  - California (elective in 2011 and 2012, mandatory in 2013)
  - Massachusetts (2014)
  - Missouri (effective August 28, 2015)
  - Nebraska (2014)
  - New York City (2015)
  - New York State (2015)
  - Pennsylvania (2014)
  - Rhode Island (2014)
  - Tennessee (2016)
  - Washington, DC (2015)

Recent Legislative Updates: Nevada

Nevada 2015-16 Tax Legislation
Commerce Tax

- On June 10, 2015, Governor Sandoval signed SB 483, enacting a new "Commerce Tax" (effective July 1, 2015)
- Business entities engaged in business in Nevada with Nevada-sitused (market-based sourcing rules) gross revenue of over $4,000,000 in a taxable year are subject to the commerce tax
- Business Entity is defined to include a "corporation, partnership, proprietorship, limited-liability company, business association, joint venture, limited-liability partnership, business trust, professional association, joint stock company, holding company, and any other person engaged in business."
- Deductions available

Nevada 2015-16 Tax Legislation

- The law also:
  - Amends Nevada payroll-based tax on financial institutions and the payroll-based business tax
  - Increases annual state business license fee applicable to certain corporations organized under Nevada law and foreign corporations authorized to transact business in Nevada
  - Extends permanently the 0.35 percent Local School Support Tax portion of the state-level sales and use tax; sales tax rate remains 6.85%

Amnesty Programs

Amnesty Programs
Current Programs

Alabama: June 30 through August 30

South Carolina: DOR to Determine

Federal Tax Methods

Revenue Recognition for Tax - Generally

Long Term Construction Contracts

- Tax methods of “percentage of completion” differ from GAAP

– *Expenses for tax generally lag GAAP (compensation accruals, reserves, etc.)*

– *Results in deferral for tax purposes*

– *Analysis to determine expense allocation method on project by project basis.*

Non-Long Term Construction Contracts (i.e. pure engineering)

- Revenue is recognized for tax purposes when substantially “all events” have occurred to earn the revenue

- Potential opportunities to defer revenue for tax purposes:

- *Retainage*
- *Award Fees*
- *Holdback*

Elements of the new GAAP standard (may or may not be allowable for Tax)

Elements allowable under 460	Elements NOT allowable under 460
• Identification of a contract • Change orders • Performance obligation satisfaction over time	• Identification of a contract – may be required “sever or aggregate” contract • Change orders – different distinctions • Performance obligation satisfaction at a point in time • Bid and proposal costs

Identifying Contracts - Tax

The tax rules for severing or aggregating contracts rely on three factors – Treasury Regulation 1.460-1(e)

1. Independent pricing of terms
2. Separate delivery or acceptance
3. Reasonable business person:
   a. *would not have entered into one of the agreements for*
   without also entering into the other agreement(s) or
   b. *would not have entered into separate agreements cont*
   to each severed contract.

Applies to contracts and change orders

Other Tax Considerations

- Simplified cost to cost method
- Year of substantial completion – 95%
- 10% method
- Look back calculation
- Variable consideration price – included for GAAP – maybe not for tax
- Bid and proposal costs

Revenue Recognition – NEW TWIST for Non-Construction

Billings in Excess of Cost (pre-bill)

- Not includible in taxable income until earned BUT
- MUST be included in taxable income no later than subsequent tax year per Revenue Ruling 2004-34

– *May result in accelerated revenue recognition for tax purposes compared to GAAP*

Interplay with Retainage / Award Fees / Holdback

- Revenues cannot be deferred if they are not yet included in income
- Accounting method considerations
- Contract by contract analysis for those

  which have BOTH a pre-bill component

  AND retainage, award fees, holdback, etc.

Meals & Entertainment

IRS issued Revenue Ruling 2008-23 clarifying the “50% haircut” pass-through rules

- Only applies on cost reimbursable contracts
- Must **<u>timely</u>** provide following details to the client on the meals and entertainment expenses:
  - Business Travel Meals
    - Amount, date, and city
  - Business Entertainment Meals
    - Amount, date, name of the establishment and its location, and names of the persons present

Common practices with Federal and State government contractors

Further clarification provided in August 2013 with final Treasury Regulations

- Expressly identify which party is subject to the Section 274 limitation

Credits & Incentives

Overview

Credits & Incentives

- Research shows that a potentially significant percentage of credit and incentive benefits go unclaimed every year in the U.S.
- Limited company resources make tracking the constantly changing incentive opportunities difficult and often cost prohibitive
- Depending upon project parameters, incentives may be available that are more advantageous than existing guidelines otherwise appear to permit
- Many incentives must be secured and approved prior to a company making public announcements or private commitments to proceed with a project
- **What are you doing?**

Types of C&I Opportunities – Three main categories

Statutory Credits / Exemptions

Tax-based off-sets authorized by statute and administered usually by a department of revenue and based on investment or jobs and sometimes on place of business activity

Employee Hiring / Training Incentives

Many states and the federal government offer off-sets (cash or tax credit) to employers for hiring targeted employees and/or providing training to employees to improve productivity and competitiveness

Discretionary Incentives

Many state and local jurisdictions offer “negotiated” or “discretionary” tax and financial off-sets to entice business activity and gain the resulting economic benefit when another jurisdiction is competing for the investments.

Types of Tax Credits & Incentives

Tax credits are typically considered “as-of-right” with incentives more often being bargained for or negotiated with state or local economic development authorities

Tax Credits	Incentives
• Capital Investment • Job Growth, Targeted Hiring, or Employee Training • Pollution Control and Environmentally Friendly • Research & Development • Childcare and Other	• Cash Grants or Other Concessions for Job Creation or Capital Investment • Utility Rate Reductions • Employee Training Grants • Sales & Use Tax Exemptions • Property Tax Abatements • Alternative Apportionment

How to identify Credit & Incentive Opportunities

Real Estate Transactions

- Relocation
- Expansion
- Consolidation
- Lease expiration
- Inbound Investments
- IPO
- M&A

Employment Projections

- Job creation
- Job retention
- Job transfer
- Job skill upgrades

Capital Investment

- Equipment expenditures
- Research & development activities
- Infrastructure improvement

Sustainability Initiatives

- Recycling
- Pollution control
- Green Initiatives
- Alternative energy

Key issues when considering credits & incentives

Question	Considerations
What are the eligibility requirements?	• Effective dates and eligible locations • Eligible industries and company size • Minimum jobs and/or capital investment • Community benefits requirements (health care, wage requirements, etc.)
What are the benefits?	• What type of benefit is being offered (grant, loans, tax incentives) • What is the range of benefit • How is the benefit calculated
What are the limitations?	• Can the company fully utilize/monetize the benefits • Is the benefit refundable, saleable or transferable • Can unused tax credits be carried forward
What are application/ reporting requirements?	• State/local agencies overseeing program • Application process • Annual/periodic filing and reporting requirements

Trends

Technology

Technology to Analyze Potential Opportunities

- Databases can be used to analyze various C&I opportunities that are available at specific locations across the country

Technology to Capture/Process Credit Information

- Work Opportunity Tax Credit
- Location-based hiring credits
- Real-time information
- Allows users to analyze and address process issues sooner
- State & Federal Online Tools

Technology to Help Address Credit Information

- Online tool that assists taxpayers with analyzing and maintaining their incentives portfolio
- Tracks due dates for incentives

Transparency

More states are adopting laws and policies that allow them to release the names and project details of any company that receives state dollars in the form of tax credits or exemptions, cash grants or in-kind contributions

- Does your organization have a policy about releasing information?
- What information will appear in the public domain?
- What information will be in the newspaper?

Third-party opportunities

Certain programs allow an otherwise non-qualified third-party vendors to look to the client’s qualifying activity. Examples are:

- California partial sales/use tax exemption for manufacturing and R&D activity
- Program provides separate exemption form for contractors
- Arizona sales/use tax manufacturing exemption at contractor level
- Utah EDTIF program
- Sales/use tax benefit must be claimed by customer

Select Credit & Incentive Programs

Select Programs

- California
  - California Competes Tax Credit (“CCTC”)
  - New Employment Credit
  - Partial Sales & Use Tax Exemption
  - Employment Training Panel (“ETP”)
- Illinois
  - Enterprise Zone (“EZ”)
  - High Impact Business Credit (HIB”)
- Missouri
  - Missouri Works Program

Select Programs

- New Jersey
  - Economic Opportunity Act of 2014
  - Grow New Jersey Assistance Program (“GrowNJ”)
  - Urban Enterprise Zone Program
- New York
  - Start-Up New York Program (“Start-Up NY”)
  - New York City Industrial Development Agency (“IDA”)
- Texas
  - Sales/Use tax or franchise tax R&D incentive

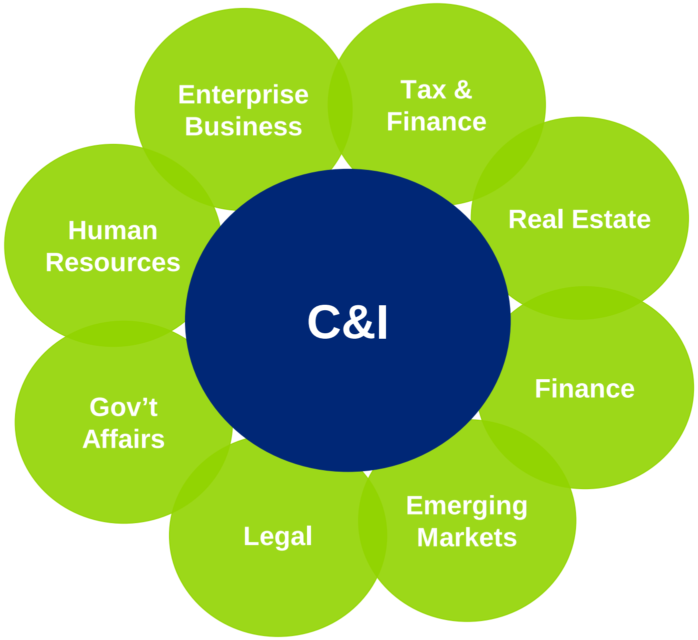
Leading Practices

Leading Practices – Areas of Focus

- Monetization
  - Centralization of internal process
  - Utilize technology
  - Proactively manage claw-backs
  - Allocate appropriate resources
  - Communicate results
- Review for currently available opportunities
  - Income tax credits
    - Refund claims
    - Prospective opportunities
  - Prospective incentive opportunities
  - Sales/Use tax refund opportunities
  - Significant current and prospective contracts
    - Tax can bring value to proposals

Leading Practices – Internal Process

Common Issues Experienced in Corporate C&I Practices	Leading Practices	Next Steps
The business units are not well positioned with regard to the potential value of C&I.	Multi-functional cooperation; Identify/communicate federal, state and international C&I triggers and potential value.	Initiate survey to measure effectiveness and conduct assessment to understand current process and structure.
The structure is not in place to educate the business units on opportunities and how to best pursue C&I.	Multi-functional cooperation; Identify/communicate C&I triggers and potential value; Persons responsible are accountable for results.	Conduct workshop to present findings of assessment and recommendations. Co-develop customized C&I process reflecting the organization's priorities.
Insufficient process and governance (structure, ownership, accountability) to mandate pursuit of C&I, the involvement and coordination of the right resources, and the tracking of C&I.	Identify and establish a leader; Ownership and governance; Process, tools and data management.	Based on the organization's capital budgeting process, establish centralized C&I process and plan implementation.
The structure is not in place to confirm that C&I programs are followed through, including application, risk management, compliance, and monetization of others' credits.	Lead function; Ownership and governance; Process, tools and data management.	Leverage technology for reporting, compliance and return on investment analysis.



Industry Considerations

How Can An Engineering Firm or Construction Contractor Help Their Client

- Make your client aware of programs applicable to their project
  - EDTIF programs
  - Federal and State New Market Tax Credit programs
  - Enterprise Zone or other location based programs
  - Green or energy efficient building incentives
- What are your client's needs?
  - Expedited permitting
  - Financial assistance with utility connections
  - Sales/use tax exemptions
  - State department of transportation infrastructure assistance
- Efficient flow of information to your client
  - Certain incentive programs allow recipients to include economic activity of third-parties associated with the project in the total project investment

New Capitalization Rules

General Framework

Effective date: January 1, 2014. May still implement in 2015.

Materials and Supplies – Treas. Reg. § 1.162-3

Dispositions/ General Asset Accounts – Prop. Reg. §§ 1.168(i)-1 and -8

Costs to ***Acquire or Produce*** Tangible Property – Treas. Reg. §§ 1.263(a)-1 and 2

Costs to ***Improve*** Tangible Property – Treas. Reg. § 1.263(a)-3

Materials and Supplies

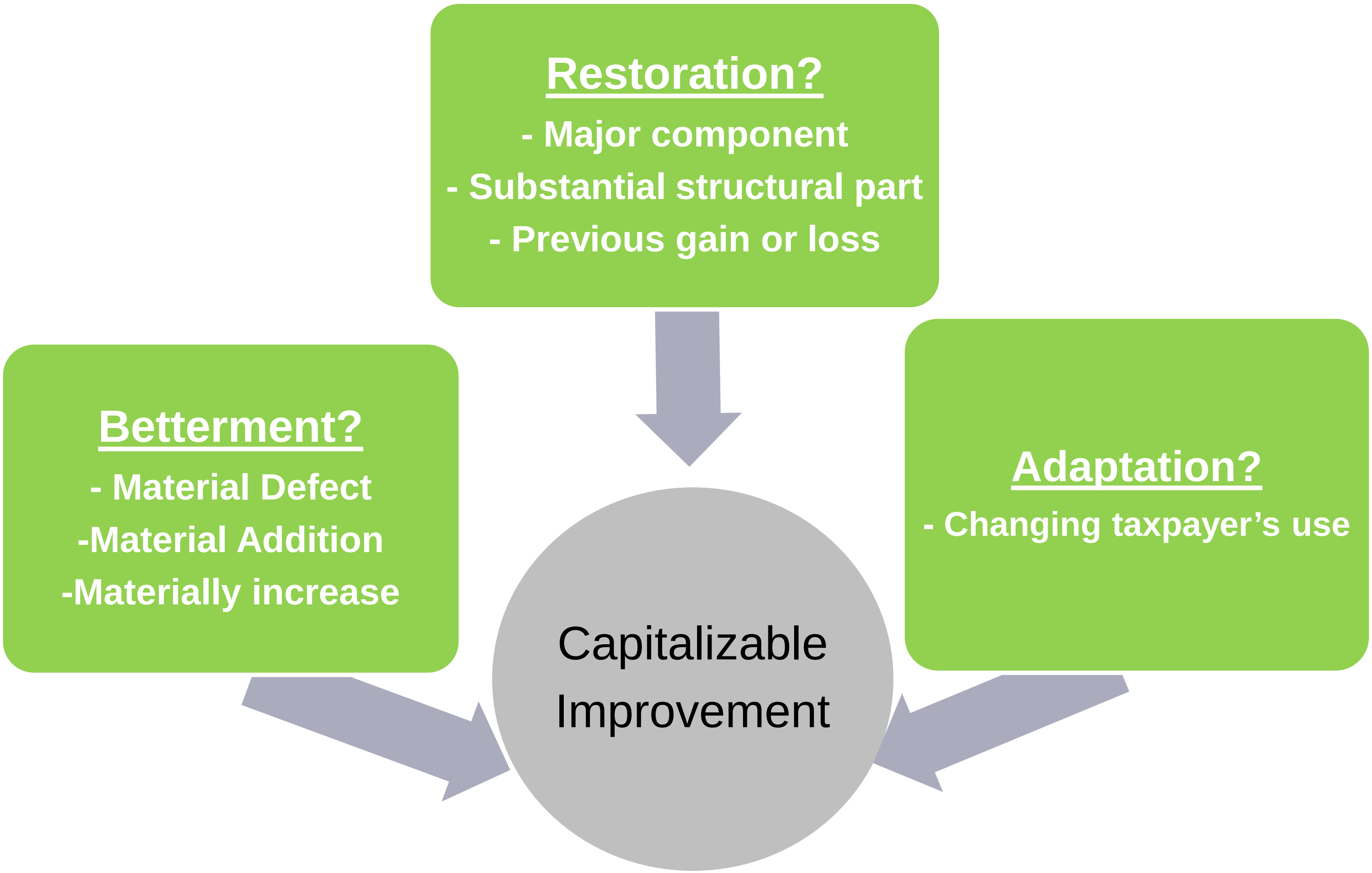
- A material and supply is tangible property used or consumed in the taxpayer's operations that is not inventory and is:
  - A component acquired to maintain, repair, or improve a unit of tangible property;
  - Fuel, lubricants, water, or similar items that are reasonably expected to be consumed in 12 months or less;
  - A unit of property that has an economic useful life of 12-months or less;
  - A unit of property with an acquisition or production cost of **$200 or less**; or
  - Property identified in future published guidance

- Materials and supplies taken into account when used or consumed for non-incidental supplies; as purchased for incidental supplies

- Special rules for rotable and temporary spare parts
  - Annual election to capitalize
  - Optional method

- Special rules apply if taxpayer makes de minimis safe harbor election

Amounts Paid to Improve Tangible Property



Elections

- De Minimis Safe Harbor Election
  - May follow book treatment for certain de minimis deductions
  - Written capitalization policy
  - May deduct amount paid for the property does not exceed $5,000 ($2,000 for taxpayers without AFS)
  - Irrevocable election
- Capitalization Election
  - May elect to capitalize amounts paid during the taxable year for repair and maintenance of tangible property that are capitalized on its books and records
  - Irrevocable election
- Partial Disposition Election
  - May elect to partially dispose of property and recognize a gain or loss on the disposition
  - Mandatory for certain dispositions (e.g., casualty)

Fixed Asset Related Opportunities

- Tangible Property Regulations
  - Deduct previously capitalized repair and maintenance expenditures
  - Dispose of property and claim a loss deduction
- Cost Segregation for new buildings and large expansions
  - Reclassify to shorter recovery periods
- Basis Recovery for previously disallowed deductions
  - Taxpayers who previously claimed the Extraterritorial Income Exclusion (ETI) may potentially recover the depreciation and amortization disallowed by virtue of its allocation to the ETI computation
- ETI on Long-Term Contracts
  - Contracts entered into between October 1, 2000 and December 31, 2006 that generate revenue from property being used outside of the U.S. in open tax years may potentially qualify for the ETI exclusion.
  - Engineering and architectural services for a construction project located or proposed for location outside of the U.S. may potentially qualify for the ETI exclusion.
  - Other services may potentially qualify: long-term maintenance, O&M contract services, equipment modernization services, standard field services.