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CREDITS & INCENTIVES TALK WITH DELOITTE

Credits and Incentives for the Aerospace and Defense Industry

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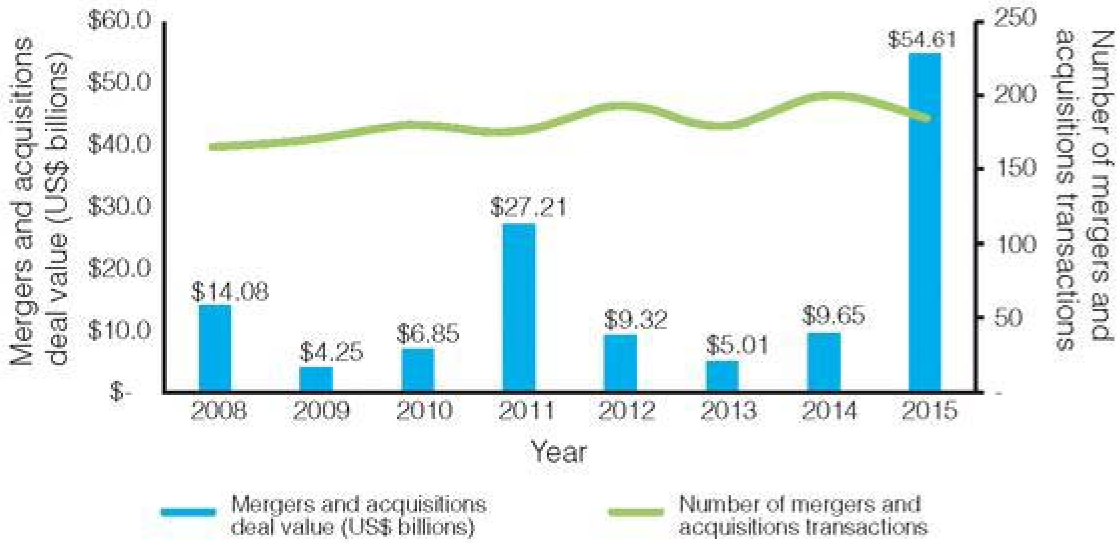
While this column has often focused on a specific credit or incentive, this month's column provides an overview of the credits and incentives available to companies in the aerospace and defense (A&D) industry sector.[1] A&D companies, as a part of their regular business cycle, can avail themselves of both statutory as well as discretionary incentives associated with activities such as research and development, employee hiring and training, real estate and capital asset investment, and sustainability initiatives. In addition, the recent spike in mergers and acquisitions (as noted in Exhibit 1) potentially may create additional credit and incentive opportunities related to post-merger integration efforts.

Exhibit 1. Global aerospace and defense sector mergers and acquisitions activity (2008 to 2015)



Source: Deloitte Touche Tohmatsu Limited (DTTL) Global Consumer & Industrial Products Industry group analysis of data from Thomson Reuters. Data through 25 November 2015.

Tax incentives tied to each of the business activities noted above are used by states (and localities) to encourage companies to relocate or expand in their jurisdiction with the goal of seeking an economic improvement to the local economy. A&D companies considering, or that have engaged recently in, mergers or acquisitions may be particularly viable candidates for such incentives, as a review of existing and future locations is a regular element of the post-merger integration process. It is also worth noting that, in certain instances, large scale A&D projects may be the catalyst for a state to enact company-specific incentive legislation.

This column outlines some of the credits and incentives which may be available to A&D companies including research and development (R&D) credits, employment incentives, and real estate and capital investment incentives.

Research and development credits

Both federal and state R&D credits may be available to A&D companies.

Federal IRC Section 41 credit for increasing research activities: The Internal Revenue Code (IRC) offers a tax credit that is potentially available to many companies, including A&D companies, for increasing their research activities. Companies satisfying the required qualifications receive a federal tax credit under IRC Section 41 based on R&D activities. For a company to qualify under this section the taxpayer must have qualified research expenses within the United States, defined as either in-house research expenses or contract research expenses.[2] In-house research expenses are further defined as any wages paid or incurred to an employee for qualified services performed by such employee and any amount paid or incurred for supplies used in the conduct of qualified research.[3] Contract research expenses are defined as 65% of any amount paid or incurred by the taxpayer to any person for qualified research.[4]

There are several other requirements under IRC Section 41 that must be satisfied before a taxpayer can qualify for a federal R&D credit, but, once a taxpayer meets the statutory requirements, it will potentially be eligible for a credit. Taxpayers may receive a credit under IRC Section 41 equal to 20% of the excess of qualified research expenses over a base amount.[5] 20% of basic research payments made to qualified organizations,[6] or 20% of amounts paid to an energy research consortium for qualified energy research.[7]

Recently, the federal R&D credit has been modified in the following manner:

1. to allow for additional prototype expenses to qualify as supply expenses;[8]
2. to allow for the election of the Alternative Simplified Research Credit on amended returns; and
3. to reduce the number of software development projects treated as "internal-use software"[9] subject to a higher qualification threshold.[10]

State research and development credits: There are also a number of states that offer R&D credits. Such state-level R&D credits tend to mirror the federal credit, at least with respect to qualification requirements and definitions.

An example of a state which allows a credit for R&D is Texas, which adopts the IRC definition of qualified research expenses. The Texas franchise tax credit equals five percent of the difference between (1) the qualified research expenses incurred during the period on which the report is based, subject to Tex. Tax Code § 171.655, and (2) 50% of the average amount of qualified research expenses incurred during the three tax periods preceding the period on which the report is based, again subject to Tex. Tax Code §

171.655. If a taxpayer is able to contract with one or more institution of higher education for the performance of the qualified R&D, the taxpayer is then entitled to 6.25% of the difference described above.

Texas has added a few other requirements regarding the credit, such as a credit claimed by a member of a combined group must be claimed on the combined report as required by Tex. Tax Code § 171.1014. The total credit claimed for the R&D credit cannot exceed 50% of the amount of franchise tax due for the report before any other applicable tax credits.[11] Any credit amount that exceeds the 50% limitation is available as a carryforward for 20 years.[12]

One unique feature of the incentive for R&D activity conducted in Texas is that qualified research expenses can alternatively be taken as a sales/use tax exemption. The exemption applies to the sale, storage or use of depreciable tangible personal property directly used in "qualified research" if the property is sold, leased, rented to or stored, or used by a person who is engaged in "qualified research." The exemption is not available if the taxpayer (or a member of the taxpayer's combined Texas franchise tax combined reporting group) claims an R&D credit on its franchise tax return for the period.

Employment incentives

Employment credits at the federal and state levels are potentially available to many employers, including those in the A&D industry.

The first of the federal programs is the Work Opportunity Tax Credit (WOTC) program which was extended by Congress in 2015.[13] The WOTC is calculated based upon a number of factors, including the target group in which the employee falls, the number of hours worked, and the wages earned. For employees working at least 120 hours but less than 400 hours, a 25 percent rate applies when calculating the credit; for employees working 400 hours or more, a 40 percent rate applies when calculating the credit.[14]

Qualified wages are defined as wages paid or incurred to individuals, who are members of a targeted group, during the first year of employment beginning with the day the individual begins working for the employer.[15] There are specific wage limitations that must be taken into account when calculating the credit. The amount of qualified first-year wages that may be taken into account with respect to each employee cannot exceed $24,000 per year (amount will vary based on the specific target group of the employee (e.g., veteran)).[16]

For an individual to potentially qualify for the WOTC, the individual must be from a targeted group as defined by the statute which includes:

- a qualified IV-A recipient,
- a qualified veteran,
- a qualified ex-felon,
- a designated community resident,
- a vocational rehabilitation referral,
- a qualified summer youth employee,
- a qualified supplemental nutrition assistance program benefits recipient,
- a qualified SSI recipient, or
- a qualified long-term unemployment recipient.[17]

A second employment-based federal credit for which an A&D company may be eligible is the Federal Empowerment Zone credit (FEZ).[18] Pursuant to IRC § 1396, the FEZ credit is a wage-based credit that is based on the applicable percentage of qualified zone wages paid or incurred during the calendar year. [19] The applicable percentage is 20%,[20] and qualified zone wages are defined as any wages paid or incurred by an employer for services performed by an employee while such employee is a qualified zone employee.[21]

A qualified zone employee refers to an employee who performs substantially all of the services within a designated empowerment zone in a trade or business of the employer, and who has a principal place of abode within the empowerment zone.[22] Empowerment zones are either designated as rural or urban. Rural programs are administered by the U.S. Department of Agriculture (USDA) and urban programs by the U.S. Department of Housing and Urban Development (HUD).[23]

In addition to the federal WOTC and FEZ credit, employment incentives at the state level should be considered. States typically offer incentives with the specific goal of stimulating the employment of individuals from targeted groups or geographies and the broader goal of improving the state's economy. Currently, at least 45 states offer state-level job creation incentives, including hiring tax credits, training incentives and discretionary incentives.

The following are some examples of state-level hiring tax credits:

- The Georgia Jobs Tax Credit provides employers a credit for creating new full-time jobs,[24] ranging from $750 to $3,500, based on eligibility of the employee and wages paid.[25]
- The Pennsylvania Tax Credit for New Jobs provides companies, creating at least 25 new jobs or

increasing employment by 20% within 3 years, a credit of $1,000 for each new job created and $2,500 for each new job filled by an unemployed individual.

- The New York Hire a Vet Tax Credit is a program (from January 2015-January 2017), under which a taxpayer can receive a credit up to $5,000 per qualified veteran, or up to $15,000 per qualified disabled veteran.[26]
- The Virginia Major Business Facility Job Credit offers employers a credit of $1,000[27] per qualified full-time employee for companies creating new full-time jobs.[28]

Training incentives: In addition to hiring credits, some states offer grants, credits, and reimbursement programs for classroom and on-the-job training an employer provides. The following are several examples:

- The Arizona Job Training Grant provides for a reimbursable grant that supports the design and delivery of customized training.[29]
- The California Employment Training Panel Grant provides a reimbursement ranging from $360 to $3,600 per employee trained for full-time employment.[30]
- The Georgia Retraining Tax Credit offers a reimbursement of up to 50% of retraining costs capped at $500 per employee per course and a total cap of $1,250 per employee.[31]
- The Texas Skills for Veterans Grant specially targets veterans and provides an employer a grant up to $1,450 per qualified veteran to be used in a 12-month period.[32]
- Washington provides an employer a Business & Occupation tax credit of up to 50% of all customized training expenses for newly hired employees.[33]

Discretionary tax incentives

To induce A&D and other companies to headquarter, locate a division, or expand existing operations in their state, various states have enacted specific incentive and tax credit programs to support economic growth.[34] These packages can include both state and municipal level incentives and extend to sales/use tax exemptions, property tax exemptions, tax credits and cash reimbursements. Several examples of these include the following:

- The Governor's Office of Business and Economic Development (GO-Biz) and the California Competes Tax Credit Committee use the California Competes Credit (CCC) to incentivize organizations to locate or grow their operations in California. Up to $200 million in CCC may be allocated in each year[35] for FY 2015-18.[36]

- Indiana incentivizes jobs creation and capital investment through the Economic Development for a Growing Economy (EDGE) program, which provides a refundable corporate income tax credit that is a calculated percentage (not to exceed 100%) of the expected increased tax withholdings generated from new job creation.[37] The credit certification is phased in annually for up to 10 years based upon the employment increases.
- The South Carolina Jobs Development Credit allows a business that qualifies (pursuant to S.C. Code Ann. § 12-10-50) and has certified to the South Carolina Coordinating Council for Economic Development that the business has met the minimum job requirement and minimum capital investment provided for in the revitalization agreement to claim job development credits.[38]
- Virginia's Commonwealth Opportunity Fund may be used by the governor to attract economic development prospects and secure the expansion of existing industry in the Commonwealth of Virginia.[39]
- Mississippi enacted the Aerospace Initiative Incentive Program, which includes a 10-year exemption from state income and franchise taxes as well as a sales and use tax exemption, for the purchase of component building materials and equipment related to start-up or expansion of a facility.[40] In order to qualify, a company must invest a minimum of $30 million and must create at least 100 full-time jobs.[41]
- Washington has enacted several credit opportunities targeted at the aerospace community. One example is the Aerospace Manufacturers Tax Incentive which gives every person engaging in the business of aerospace product development (in Washington) for others, a reduction in the associated Business and Occupation tax liability.[42]

Statutory tax credits

A&D companies are also potentially eligible to receive statutory tax credits. A few examples of these credits include the following:

- For businesses located in an Arizona Military Re-Use Zone for Aviation or Aerospace companies, Arizona provides a state tax credit based on net increases in employment by the taxpayer of full-time employees working in a military reuse zone.[43] These employees must be primarily engaged in providing aviation or aerospace services, but this also includes manufacturing, assembling, or fabricating aviation and aerospace products.[44] The amount of the credit is calculated with respect to each employee (other than dislocated military base employees) and is equal to: 1st year of employment—$500; 2nd year of employment—$1,000; 3rd year of employment—$1,500; 4th year of employment—$2,000; and 5th year of employment—$2,500.[45]

- Colorado offers an Aviation Development Zone Tax Credit. Pursuant to this program, a business or any portion of a business that is involved in the maintenance, repair, completion or modification of aircraft located within the boundaries of an aviation development zone may qualify for a state income tax credit of $1,200 per new full-time employee.[46]
- The District of Columbia offers a Qualified High Technology Company (QHTC) incentive package that includes a number of items, including an exemption from the corporate or unincorporated income tax rate for up to five years.[47] A QHTC is then afforded a reduction from 9.2% to 6% each year thereafter. The District also offers several other credits and incentives to a QHTC, including a wage reimbursement equal to 10% of the wages paid during the first two years of employment to a qualified employee, up to $5,000 for each person hired,[48] a 10-year abatement of qualified personal property tax,[49] and an exemption from sales tax on the purchase of hardware and software.[50] For purposes of the above, a QHTC is defined as an individual or entity organized for profit and leasing or owning an office in the District, having two or more qualified employees in the District, and deriving at least 51% of its gross revenues[51] from qualifying high technology activities earned in the District.[52]
- Maryland has enacted the Security Clearance Administrative Expenses and Construction and Equipment Costs Tax Credit. Under this program, an individual or a corporation may claim credits against the state income tax for security clearance administrative expenses (not to exceed $200,000).[53]
- Washington offers aerospace companies a credit against Business and Occupation tax. The credit is specifically allowed for a manufacturer or processor for hire of commercial airplanes or components of such airplanes.[54] This credit is equal to the amount of qualified aerospace product development expenditures of a person, multiplied by the rate of 1.5%.[55]

Conclusion

These are just some examples of the incentives that may be available to A&D companies and are intended to demonstrate that credits and incentives can be impactful for an industry that continues to make significant investment in assets and people.

[1] The A&D industry sector or A&D companies refers to companies that manufacture or provide services for defense products, such as aircraft, watercraft, weaponry, and information systems, and companies manufacturing aircraft and spacecraft. Typically, the federal government is the largest purchaser of domestic A&D products and services.

[2] IRC Section 41(b)(1)(A) & (B).

[3] IRC Section 41(b)(2)(A). Subsection (iii) expands this area to include any amount paid or incurred to another person for the right to use computers in the conduct of qualified research, pursuant to regulations prescribed by the Secretary, and certain other qualifications.

[4] IRC Section 41(b)(3)(A).

[5] IRC Section 41(a)(1).

[6] IRC Section 41(a)(2).

[7] IRC Section 41(a)(3).

[8] Final regulations issued by the IRS on July 17, 2014 regarding Section 174.

[9] Final regulations became effective on February 27, 2015.

[10] These proposed regulations were released in 2015, but are not yet final.

[11] Tex. Tax Code Ann. § 171.658.

[12] Tex. Tax Code Ann. § 171.659.

[13] Pub. L. No. 114-113, 129 Stat. 2242.

[14] IRC Section 51(a).

[15] IRC Section 51(b)(1) & (2).

[16] IRC Section 51(b)(3).

[17] Full list found at IRC Section 51(d)(1)(A)-(J).

[18] The FEZ credit and the WOTC both coordinate with each other under IRC Section 1396(c)(3), which means that qualified zone wages for purposes of the FEZ credit will not include wages that have been taken into account in determining any credit under the WOTC.

[19] IRC Section 1396(a).

[20] IRC Section 1396(b).

[21] IRC Section 1396(c)(1).

[22] IRC Section 1396(d).

[23] Pub. L. 103-66, 107 Stat. 312, at Subchapter C, Part I, Sec. 13301.

[24] Ga. Comp. R. & Regs. 560-7-8-.36(9)(a). The benefits and requirements for the Job Tax Credit depend on the county where the jobs are located. An eligible business must continue to satisfy the applicable minimum job threshold throughout the five-year period in order to continue to claim the credit.

[25] Ga. Code Ann. § 48-7-40.

[26] N.Y. Tax Law § 606.

[27] Va. Code Ann. § 58.1-439.

[28] The qualifying threshold amount for new jobs is 50 new jobs in Tier 1 locations and 25 new jobs in Tier 2 locations (locality identified by the Virginia Economic Development Partnership as an economically distressed area or has been designated as an Enterprise Zone).

[29] Ariz. Rev. Stat. Ann. § 41-1541.

[30] Cal. Unemp. Ins. Code § 10214.5.

[31] Ga. Code Ann. § 48-7-40.5.

[32] Tex. Gov't Code Ann. § 431.006.

[33] Wash. Rev. Code § 82.04.449.

[34] Many states statutorily authorize the governor's office or an economic development agency to negotiate these tax incentive packages with businesses.

[35] In addition to any unallocated CCC amount from the preceding fiscal year and the amount of any previously allocated credits that have been recaptured.

[36] Cal. Rev. & Tax. Code § 18410.2. The California Competes Tax Credit Committee has the authority to approve or reject any written agreement submitted from the governor's office of business and economic development for tax credit allocation by resolution at a public meeting.

[37] Ind. Code § 6-3.1-13-18.

[38] S.C. Code Ann. § 12-10-50.

[39] Va. Code Ann. § 2.2-115.

[40] Miss. Code Ann. § 57-113-3.

[41] https://www.mississippi.org/assets/incentives/mississippi-aerospace-incentives-program.pdf.

[42] Wash. Rev. Code § 82.04.29.

[43] Ariz. Rev. Stat. Ann. § 43-1079(A).

[44] *Id.*

[45] *Id.* at (A)(1).

[46] Colo. Rev. Stat. § 39-35-104(1).

[47] D.C. Code § 47-1817.06(a)(1).

[48] D.C. Code § 47-1817.03(a).

[49] D.C. Code § 47-1508(a)(10)(A).

[50] D.C. Code § 47-2005(31).

[51] D.C. Code § 47.1817.01(5)(A)(iii).

[52] D.C. Code §47-1818.01(5)(A).

[53] Md. Code Ann., Tax-Gen. § 10-732(b)(1).

[54] Wash. Rev. Code § 82.04.4461(a)(1)(i).

[55] Wash. Rev. Code § 82.04.4461(a)(2).