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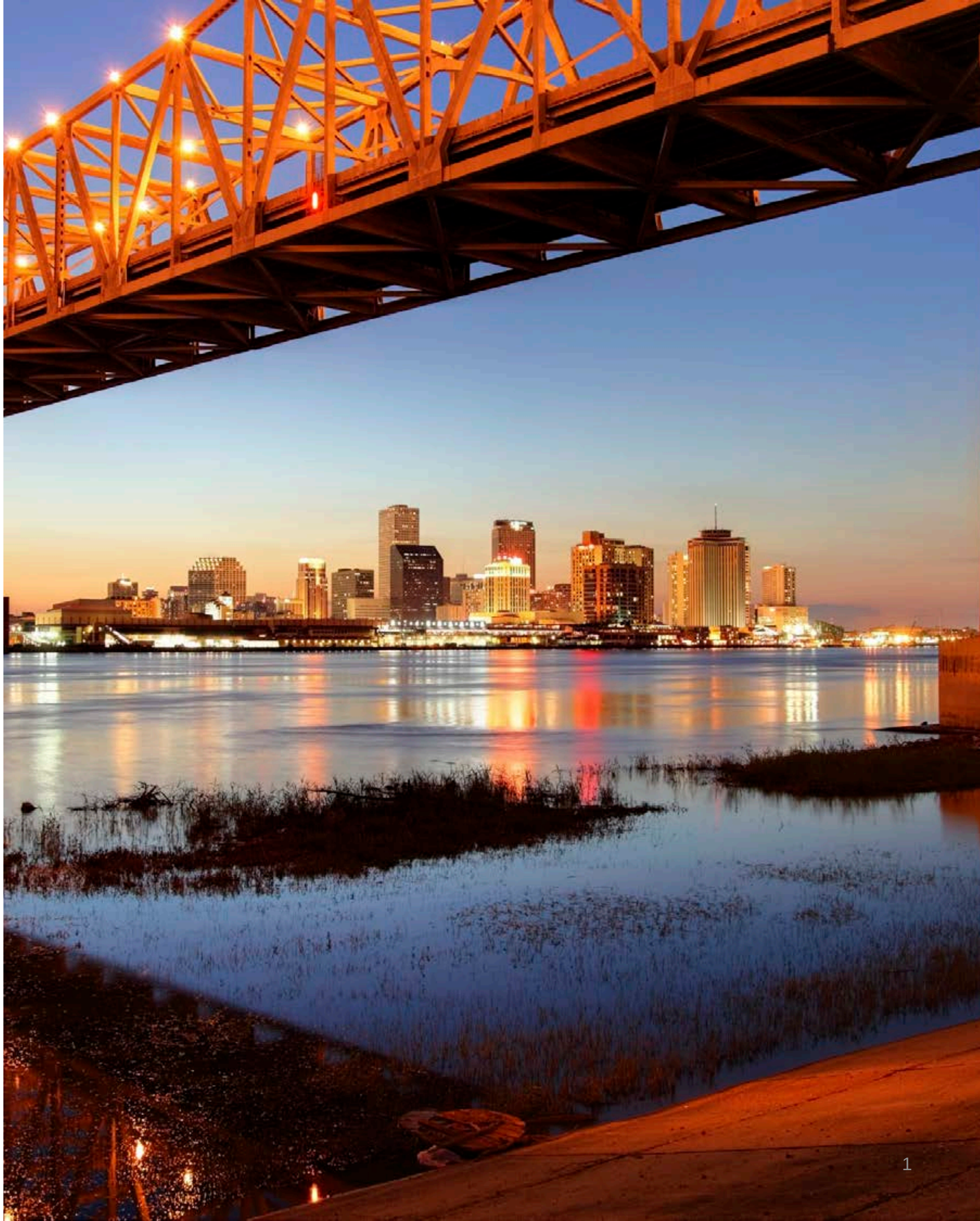
2015 Engineering & Construction Conference

State and Local Tax Considerations + Credits and Incentives



Agenda: Federal Tax Update for E&C Firms

Research & Development Credits

Section 199 – Qualified Production Activities

Section 41 – Research & Development Tax Credit

R&D Tax Incentives Overview
Opportunity Areas
Rights & Risk
Geosyntec Consultants, Inc. v U.S.
R&D Legislative Update

R&D Tax Incentives Overview

"Traditional" 20% research credit available through 12/31/2014

- *Requires establishing the company's qualified research expenditures and gross receipts during 1984 – 1988*

Alternative Simplified Credit ("ASC") option for 2007 – 2014

- *14% credit to the extent current-year qualified research expenses exceed 50% of average qualified research expenses for three preceding taxable years. (12% in 2007– 2008)*
- *Taxpayer may get credit without increasing R&D spend*
- *ASC benefits companies that:*
  - Currently have limited credit opportunities due to increasing gross receipts
  - Have difficulty determining their "regular' base amount due to lack of substantiation from the 1984–1988 period
  - Are smaller companies that cannot justify the compliance cost of reconstructing historic data from the 1984–1988 period
- Many states offer comparable R&D incentives (all but seven)

R&D Tax Incentives Overview

Qualified research expenditures are evaluated based on the application of specific criteria to activities performed by a company

- Where the activity meets specified criteria, certain expenditures related to the activity may then be included in calculating the tax credit
- Generally, new product and process development activities qualify, and in the context of engineering, design or construction projects, the focus is generally on the unique components of asset / structure designs and / or construction processes and means or methods
- Additionally, activity that directly supports or directly supervises qualified research activity is also qualified activity
  - Support can include administrative assistants, technicians, certain maintenance and field personnel
  - Supervision can include direct interaction with personnel performing qualified research activity (first-line management)
  - Furthermore, if substantially all (80% or more) of the activity is qualified, the taxpayer can include 100% of the wages associated with that activity

R&D Tax Incentives Overview

The Four Statutory Criteria:

(Must have all four)

Permitted Purpose

The activity must relate to a new or improved product or process intended to improve:

- Function
- Performance
- Reliability
- Quality

Elimination of Uncertainty

The activity must be intended to discover information to eliminate uncertainty related to:

- Capability of a product or process
- Method of a product or process
- Appropriateness of a product design

Technological in Nature

The activity performed must fundamentally rely on principles of:

- Physical science
- Biological science
- Computer science
- Engineering

Process of Experimentation

Substantially all of the activities must relate to a process of experimentation involving:

- Evaluation of alternatives
- Confirmation of hypothesis through trial and error, testing and/or modeling
- Refining or discarding of the hypothesis

R&D Tax Incentives Overview

Eligible Research Costs

- Wages:
  - Box 1, W-2 wages
  - Excludes 401(k), benefits, & overhead costs
  - Includes individuals performing, directly supporting or directly supervising qualified activities
- 65% of Contract Research:
  - Where the taxpayer pays someone other than an employee to perform qualified research
  - Fees paid to engineering consultants, outside design firms, and sub-consultants
  - *The taxpayer must bear the economic risk and retain rights in the results of the research*
- Supplies:
  - Items used or consumed in the qualified activity
  - Costs to fabricate prototypes, mock-ups

Opportunity Areas – E&C Project Lifecycle

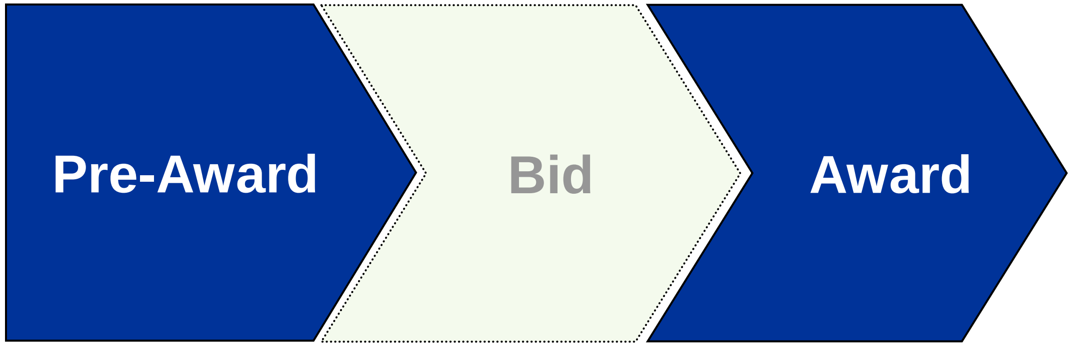
Pre-Award / Bid / Proposal

- Research process typically begins in the pre-award phase, regardless of whether it is bid-build or design-build arrangement or if a constructor or designer is involved
- Engineers and/or designers prepare preliminary designs, conduct feasibility studies, develop engineering value add concepts, and evaluate construction processes or asset / structure designs prior to the time the contract is awarded
- Pre-Award work is typically self-funded by the designer or contractor, regardless of whether they are ultimately awarded the project – the cost of chasing the work
NOTE: Exceptions exist for FEED projects or certain industries (i.e. power generation)
- Time not generally well tracked during the pre-award phase

Awarded Jobs / Projects

- Costs from the pre-award phase do not generally transfer to the awarded project in the accounting system
- New project is opened in the project tracking or job cost system, and post-award costs are generally well tracked, with the specifics often left to the discretion of the project manager or job superintendent

Opportunity Areas – E&C Project Lifecycle



Pre-Award Activities

- Analyzing conceptual design alternatives to select a design upon which to estimate and place a bid.
- Computer aided simulations and analysis
- Planning and engineering the structure's design and associated construction process.
- Mock-ups, test pours, models, etc.
- Subcontractor design and testing services performed.

Award Activities

- Design reviews/value added engineering
- Development of structure requirements, site constraints, etc.
- Designer/draftsmen
- Detailed design work to bring structure and/or construction process design to 100% completion.
- Subcontractor design and testing services performed.
- Design changes/change orders
- Construction issues/obstructions

Opportunity Areas

The following project traits can potentially indicate qualified activities:

- Evaluating alternative design and/or build concepts
- Iterative calculations and/or drawings
- Developing a model and/or running simulations
- Analyzing technology/equipment/process alternatives for feasibility
- Iterative component/system design
- Design of temporary structures (SOE/formwork/falsework)
- Construction methods/materials alternatives evaluated
- Problems/obstructions encountered during design or construction (not resource or schedule issues)
- Problems during construction, post installation, or during warranty period

Who Owns the Research? Who Bears the Risk of Loss?

The Taxpayer must (1) retain substantial rights to the research; and (2) bear the risk of research failure. When both these requirements are met, the research is not considered "funded."

- Rights to research
- *Rights need not be exclusive (a right to use the research results in the taxpayer / contractor's business is sufficient). Lockheed Martin Corp. v. United States, 210 F.3d 1366, 1375 (Fed. Cir. 2000).*
- *If not expressly stated, there may be implied rights*
- Risk of research failure
- *Taxpayer must bear the expense even if research is unsuccessful*
- *Key contract provisions impacting risk of loss:*
  - Final and provisional acceptance
  - Warranties
  - Remedies
  - Overall payment terms

Who Owns the Research? Who Bears the Risk of Loss?

Contract Types

- Generally excluded from a R&D analysis:
  - Cost Plus %
  - Cost Reimbursable
  - Time and Materials
  - Hourly
  - Cost Plus Fixed Fee
  - Force Account
  - Cost Plus Guaranteed Max (see *Geosyntec Consultants, Inc. v United States, 11th Circuit)*
  - Projects performed outside the United States
- Considered for evaluation for a R&D analysis:
  - Lump Sum / Fixed Fee
    - The Owner pays a predetermined amount. The designer or contractor is at risk to complete all tasks included in the scope of the project regardless of how much time or money it costs.
  - Unit Price
    - Owner pays the designer or contractor a fixed sum for each completed unit of work. This allows flexibility in the contract in the event quantities change but the designer or contractor is still at risk for the entire cost of the completed work on a per unit basis.
- Joint ventures can be eligible for the research credit

Geosyntec Consultants, Inc. v. US, 9:12-cv-80334 (S.D. Fla. 4/15/13)

- Plaintiff is a consulting and engineering firm specializing in environmental studies, infrastructure engineering and natural resource assessment and restoration.
- Plaintiff sued for a refund of $1,677,432 for research credits for qualified research performed under 370 contracts (8% of total projects) for the years 2002–2005.
- The narrow issue before the Court was whether the claimed credits relate to activities “funded” by their clients because payment was not contingent upon the success of the research.

Geosyntec Consultants, Inc. v. US (cont.)

- While the funding issue also turns on whether the contractor retained “substantial rights” in the research results, the parties postponed consideration of that issue, i.e., the narrow issue before the Court was whether payment was contingent upon success of the research.
- The parties agreed to a judgment sample of 6 projects: (i) 3 sample contracts were firm fixed price and (ii) 3 other sample contracts were cost-plus with a cap.

Geosyntec Consultants, Inc. v. US (cont.)

- Firm Fixed Price Contracts:
  - The IRS argued that the Plaintiff did not guarantee success under any of the contracts and, therefore, the work was funded to the extent of the consideration they received.
  - The Court rejected the IRS argument that there must be a specific metric-based performance guarantee. Rather the Court considered a number of factors in deciding that payment was contingent upon the success of the research:
    - First, the taxpayer bore the risk because payment was contingent upon the “client’s affirmative acceptance of satisfactory research performance.”
    - Second, the fixed-price shifts the risk to the taxpayer because it will not be reimbursed for cost overruns.
    - Third, the warranty and default provisions in the contract further shifted the risk to the contractor in the event the research failed.

Geosyntec Consultants, Inc. v. US (cont.)

- Capped Contracts Payable on a Cost-Plus Basis:
  - The Court agreed with the IRS that these contracts were funded for the following reasons:
    - First, under the subject contracts, the invoices must be verified by designated project managers of ***both the taxpayer and his customer;*** as distinguished from the other fixed-price contracts where payment was due *only if the customer was satisfied with the outcome* of the research.
    - Second, the contract specified the tasks performed by the contractor at set rates pursuant to a detailed budget — which is distinctly different than the risk faced by the contractor who gets paid only if tasks are performed to the satisfaction of the customer.
    - Third, while the Court recognized that the customer could dispute the submitted invoice, the court concluded that this fact alone was not sufficient to shift the risk of payment to the contractor.

Geosyntec Consultants, Inc. v. US (cont.)

- Fourth, the taxpayer could submit change orders to address changes in the scope of the project thereby mitigating the risk of cost overruns.
- Sixth, one contract specified that the "Plaintiff does not guarantee results, only compliance with professional standards is required."
- Seventh, the parties agreed that cost-plus contracts without a cap are "funded" because payment is due regardless of the success of the research. The Court considered whether the capped price shifted the risk to the contractor; ultimately concluding that this added feature, in-and-of-itself, did not provide a basis for concluding that the contractor sufficiently carried the financial risk in the event of failed research.

R&D – Legislative Update

- Credit expires on 12/31/2014, but is highly likely to be extended:
- *Legislation to permanently extend the research and experimentation tax credit cleared the House of Representatives on May 20 by a vote of 274-145*
- *Support did not fall entirely along party lines, with 37 Democrats breaking ranks to vote "aye"*
- *The bill, which includes no revenue offsets, faces an uncertain future in the Senate and a veto threat from the Obama administration*

http://newsletters.usdbriefs.com/2015/Tax/TNV/150522_1.html?elq=1bd45dd324204cc698110bb20295470e&elqCampaignId=3368&elqaid=7584&elqat=1&elqTrackId=aeba024090fd47c8ad0e2ae90b51b19c

Section 199

Qualified Production Activities Deduction

Qualified Production Activities Income

Deduction related to qualified domestic production activities, which includes:

- *<u>architectural</u> projects associated with construction of real property in the United States*
- *<u>engineering</u> projects associated with construction of real property in the United States*
- *<u>construction</u> of real property in the United States*

- Effective for taxable years beginning after December 31, 2004
- Deduction is currently 9% of Qualifying Production Activity Income (QPAI) or Taxable Income
- Profit Driven Calculation
- Permanent deduction impacting effective tax rate
- Can provide significant cash tax savings

Qualifying Production Activities Income

How is the Deduction Calculated?

- *Qualifying Receipts*
- *Less:*
  - Direct costs allocable to qualifying receipts
  - Other expenses, losses, or deductions allocable to qualifying receipts
- *Equals:*
  - Qualified Production Activities Income (QPAI)
- *Lesser of QPAI or TI times 9%*
  - Also applies to taxpayers paying AMT
- *Equals:*
  - Section 199 Deduction (subject to W-2 wage limitation)

How the E&C Industry Qualifies:

Qualification Questions that need to be answered:

1.Does the construction relate to real property within the U.S.?

- *New construction vs. substantial renovation*

2. Is the taxpayer in the normal business of construction?

- *NAICS codes (i.e. 23)*

3. Is the taxpayer engaged in construction activities?

- *General contractor*
- *Subcontractor*
- *Project manager*

4. Are the receipts derived from construction?

- *Does not include rental or lease receipts*
- *Includes gains on sale of real property*
- *Includes construction / engineering service receipts*

Approaching the Calculation

Project qualification approach:

•Contract review by project / Item by Item analysis

- Scope of work
- Location of project
- Identifying non-qualifying services

•Project manager discussions

•Determining available financial data

•Reconciliation of G/L to job cost reports and tax return reporting

Implications to E&C industry:

- Item by Item analysis
- Review Customer Agreements
- Repair vs. Substantial Renovation

Special Rules

Qualification

- Contract manufacturing: benefits and burdens
- Government contractors
- Shrink-back
- EAG: attribution of activities

Expense Apportionment

- Flow-through entities
- Intercompany transactions
- Prior Period Expenses

IRS Guidance and Case Law

Construction Activities

- Gibson & Associates, Inc., 136 T.C. 10 (2011).
  - Taxpayer friendly result

Value Added Production

- Timothy J. Dean (Houdini) Case., 964 F Supp. 2d 1110

Benefits and Burdens

- Industry Director Directives LB&I-4-0112-001 issued 2/1/2012 and LB&I-04-0713-006 issued 7/26/2013 – B&B Analysis in Contract Manufacturing Arrangements

Software

- Online Software CCA 201226025
- Computer Software TAM 131376-13
- Computer Software GLAM 2014-28841-1

Section 199 – Legislative Update

- Proposals:
  - Republican (Camp) = phase-out and repeal section 199
  - Democrat (Wyden) = immediate repeal of section 199
  - President = 2 tier proposal:
    - Increase §199 deduction to 10.7% (from current 9%)
    - Advanced manufacturing would get an even higher §199 rate (but the President has not specified the rate nor defined “Advanced Manufacturing”)

Agenda: State and Local Credits and Incentives

Overview

Trends

Select Credit & Incentive Programs

Best Practices

Industry Considerations

Appendix of Select Credit & Incentive Programs

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.

Overview – Federal Programs

- Federal credits are primarily statutory credits tied to specific activities within a company
- The methodology to claim federal credits varies, depending on the specific program
  - Some credits are claimed directly on the current year tax return
  - Some credits are awarded through competitive, application-based programs
  - Some credits are acquired through transactions with third parties

Overview – State Statutory vs. Negotiated

- Statutory Credits/Exemptions
  - Tax-based offsets authorized by statute
  - Typically administered by a department of revenue and based on investment or jobs and sometimes on place of business activity
  - Benefit: Generally 1% - 6% of qualified investment and $500 - $12,000 per qualified employee

- Discretionary Incentives
  - Foreign, State and local jurisdictions offer “negotiated” or “discretionary” tax and financial offsets to encourage business activity and gain the resulting economic benefit when another jurisdiction is competing for the investments
  - Must meet the “But For” test
  - Benefit: Up to 10% of initial project costs and/or 5% of ongoing operating costs
  - What is being offered? / What do you need?

Overview – State Training Programs

- States offer offsets to employers for training employees to improve productivity and competitiveness
  - Offsets can be in the form of cash or tax credits
  - Businesses must apply to the applicable state or other agency for funds and must detail the training to be provided and provide justification for funds requested
  - Benefit: Generally 33% to 66% of qualified expenses

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

- **Relocation:** In April 2014, an automaker moved its US headquarters from Torrance, California to Plano, Texas.
- **Consolidation:** In early 2014, a consumer product manufacturer opened a 40,000 square foot facility in Kalamazoo, Michigan to consolidate 15 industrial design teams at their first global design center.
- **Capital Investment:** In 2014, a heavy truck transmission manufacturer plans to spend $700 million on tooling and machinery.

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

Types of C&I Opportunities

Availability of incentives is generally dependent upon new capital investment, job creation/retention, location, wages/income, governmental budgets, and the political climate.

	One time	Recurring
Cash $	• Cash grant • Land cost write-down • Sales/use tax exemptions • Site grants (grading, utility extensions, etc.) • Free soil/environmental grant • Forgivable loans/grants • Utility improvement grants • Refundable tax credits	• Property tax abatement • Reduced property assessment • Reduced rent • Reduced utility rates • Utility tax exemptions • Tax increment financing
In-kind $	• Zoning/covenant variances • Permit waivers • Relocation assistance • Hiring assistance • Temporary space • Power reliability improvements	• Corporate income tax credits (subject to actual liability) • Low-interest loans/financing • Customized training • Enterprise zone credits • Special investment districts

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 news paper?

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”)
  - Economic Redevelopment and Growth Program (“ERG”)
- New York
  - Start-Up New York Program (“Start-Up NY”)
  - Employee Training Incentive Program
- Texas
  - Sales & Use tax or franchise tax R&D incentive
- Utah
  - Economic Development Tax Increment Financing

Best Practices

Credits & Incentives Best Practices

Common Issues Experienced in Corporate C&I Practices	Best 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 help ensure 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.

Monetization Best Practices

- Centralization of internal process is key
- Utilize technology
- Proactively manage claw-backs
- Allocate appropriate resources
- Communicate results

Industry Considerations

How Can You Help Your 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
- Consider how an applicable program could result in competitive pricing – What are your client's needs?
  - Expedited permitting
  - Financial assistance with utility connections
  - 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

Contacts

Michael Locascio

Tax Director

Deloitte Tax LLP, San Francisco Office

415-783-6041

mlocascio@deloitte.com

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Appendix

Select State Programs

California

California Competes Tax Credit (“CCTC”)

The opportunity — CCTC

An income tax credit available to businesses that want to locate, expand or retain operations in California

Per GO-Biz, the amount of CCTC incentives available, by year, is as follows:

- $150 million for fiscal year 2014/15
- $200 million in each fiscal year 2015/16–2017/18

Legislative updates:

- Provides for a competitive negotiated incentive against personal income or corporate income tax
- The CCTC will be administered by GO-Biz and the availability of the incentive will be subject to a competitive application process
- Written agreements between taxpayer and GO-Biz must be approved by the California Competes Tax Credit Committee

All CCTC awards will be made publicly available upon approval

CCTC — Credit amount based on 11 factors

Number of jobs created or retained

Compensation paid to employees

Amount of Investment

Extent of depressed economic activity in the business area

Opportunity for future growth and expansion

Other incentives available in California

Incentives available in other states

Duration of proposed project & duration of commitment to remain in the state

Extent the benefit to the state exceeds the amount of the tax credit

Overall economic impact

Strategic Importance to state, region, or locality

CCTC — Tax credit mechanics

- The credit is non-refundable
- The CCTC has a 5 year carry forward starting the year after the credit is allocated
- Each approved tax credit agreement will specify the terms of when the credit may be claimed
- The CCTC agreement shall contain provisions that shall recapture the tax credit in whole or in part if the applicant fails to fulfill the terms and conditions of the written agreement
- The FTB shall have access to the application and any and all documentation provided in the decision to approve the agreement and allocate the credit for audit purposes

California New Employment Credit

- Credit for qualified wages of qualified full-time employees working in a "designated geographical area" for companies that create new jobs
- Benefit Amount: 35% per year, for five years, of wages between 150% and 350% of minimum wage
- Must receive a Tentative Credit Reservation ("TCR") for each qualified full-time employee
  - You must request a TCR within 30 days of completing the Employment Development Department (EDD) filing requirements
- To be eligible, a qualified full-time employee must satisfy any of the following conditions
  - Unemployed for six months immediately preceding hire
  - Veteran separated from the U.S. Armed Forces
  - Recipient of the Earned Income Tax Credit
  - Ex-Offender
  - Current recipient of CalWORKS

California - New Partial Sales & Use Tax Exemption

- Exemption applies to the state portion of the sales tax rate (4.1875%); local and district sales tax rates still apply
- The exemption is available to qualified persons (as defined), without an application process
- Applies to purchases of certain manufacturing and research and development equipment
- The exemption became available for qualified purchases beginning July 1, 2014
- Limited to $200 million in purchases each year
- Purchases in excess of $200 million are subject to tax at the full tax rate
- Qualifying purchases must remain in California and be used in a qualified activity for the first 12 months
- Purchasers must provide retailers with an exemption certificate

California – New Partial Sales & Use Tax Exemption

- A qualified person is one primarily engaged (50% or more) in a business activity that is described in the following North American Industry Classification System (NAICS) Codes
  - NAICS Codes 3111-3399, which describes the manufacturing sector as a whole
  - NAICS Codes 541711 or 541712, which describe research and development activities, including for biotechnology and life science
- Qualified property includes machinery and equipment with a useful life greater than one year, used primarily (more than 50%) in manufacturing, processing, fabricating, refining or recycling of tangible personal property, as well as research and development, anywhere in California
  - Also includes property used to maintain, repair, measure or test other qualified property, including repair parts, property used in research and development and certain packaging equipment

California – Employment Training Panel

- The California Employment Training Panel ("ETP") is a state agency that annually awards millions of dollars in training grants to employers that train their California based workforce
- ETP is expecting to receive $90m in funding for the FY15/16 year
  - Cap: $750,000 for single employers
  - Benefits are based on the number of employees participating in training and the number of hours each employee is involved in approved training
  - Qualified classroom training is reimbursed at $15 - $22 per hour per trainee based upon industry of the applicant
  - Qualified computer based training is reimbursed at $8 per hour per trainee, limited to not more than 50% of total training
  - Advanced technical training is reimbursed at $26 per hour per trainee
- Funds are applied for on a prospective basis and are not available for previously-conducted trainings
- Application process for FY15/16 opened on May 1

Illinois

Illinois

- Illinois Enterprise Zone (“EZ”): On August 7, 2012, law signed providing various amendments to the Illinois EZ Act.
  - Eliminated EZ job tax credits that offset the corporate income tax
  - Eliminated the EZ dividend deduction for corporate taxpayers
  - Created additional criteria for EZ qualification and removed the requirement that an area be a depressed area for EZ qualification
  - Businesses located near the boundary of an EZ may request an EZ expansion under certain circumstances
- High Impact Business (“HIB”) Credit: Signed into law on August 7, 2012; businesses not located in an EZ may be eligible for HIB designation
  - An HIB is a business that:
    - Creates 500 jobs and invests $12M, or
    - Retains 1,500 jobs and invests $30M
  - Various credits and negotiated incentives are available to businesses with HIB designation

Kansas

Kansas

- Promoting Employment Across Kansas
  - Payroll withholding tax credit for companies that invest and pay high wages in Kansas. Includes some expansion and retention activities as well
  - To qualify, companies must create at least 10 new jobs within two years in metropolitan areas or 5 new jobs within two years in rural areas
  - Effective July 1, 2014, companies in the bioscience industry may also be considered for PEAK if funding under the Kansas Bioscience Authority is not an option

Missouri

Missouri

- Missouri Works Program:
  - Qualified businesses that meet job creation, capital investment and wage thresholds may be eligible for tax credits based on the payroll of new jobs
  - Benefit may be claimed for up to 5 year for new companies and 6 years for existing companies
  - The credit is refundable and transferable
  - This program is application based

New Jersey

New Jersey

New Jersey Economic Opportunity Act of 2014 (A-3213)

- NJ Assembly Bill 3213, signed into law on October 24, 2014, made significant modifications to the New Jersey Incentives Regime:
  - Atlantic City added to the Garden State Growth Zones
  - Job calculation credit changed for retained jobs for most projects
  - Removed site acquisition costs from the definition of capital investment
  - Removes cap on the value of credits approved by the Economic Development Authority
- Benefits only available to qualifying businesses & projects
- No new applications will be accepted for programs being phased out by A-3680

New Jersey

- Grow New Jersey Assistance Program (“Grow NJ”)
  - Grow NJ is now the main job creation incentive program offered by NJ.
  - Base tax credits ranging from $500 to $5,000 per job, per year with potential bonus tax credits ranging from $250 to $3,000 per job, per year.
    - New full time jobs qualify for 100% tax credits.
    - Retained full time jobs generally qualify for 50% tax credits.
  - Benefits available for a period of ten years.
  - A qualified business must create or retain approximately 10 to 50 full-time jobs to qualify for Grow NJ (Previously 100 jobs):
    - 10 new or 25 retained full-time jobs for technology start up or manufacturing companies;
    - 25 new or 35 retained full-time jobs for businesses in certain other targeted industries*;
    - 35 new or 50 retained jobs for other qualified projects.

*"Targeted industry" means any industry identified from time to time by the authority including initially, a transportation, manufacturing, defense, energy, logistics, life sciences, technology, health, and finance business, but excluding a primarily warehouse or distribution business.

New Jersey

- Economic Redevelopment and Growth Program ("ERG")
  - The ERG is a discretionary incentive grant program administered by the New Jersey Economic Development Authority (NJEDA) for real estate development projects that have a financing gap
    - Applies mainly to commercial projects, residential projects may be excluded from certain benefits
  - ERG grants are based upon net additional tax revenues received by the state and the local jurisdiction in which a development project occurs for a period of up to 20 years
  - The redevelopment project must be located in a qualifying economic and redevelopment grant incentive area
  - The amount of the ERG Grant can be up to 75% (or 85% in a Garden State Growth Zone) of the annual incremental state tax and/or local tax revenue resulting from the project, but may not amount to more than 30% (40% in a Garden State Growth Zone) of the total cost of the project
  - All projects are subject to a comprehensive net benefit analysis to verify that the revenues New Jersey receives will be greater than the incentive being provided

New York

New York

- Employee Training Incentive Program: Provides a refundable tax credit for qualified activities equal to 50% of eligible training costs up to $10,000 per eligible trainee
- Real property tax credit for manufacturers equal to 20 percent of the real property taxes paid on owned or leased property principally used during the taxable year for manufacturing.
- The Excelsior Job Program was amended to include companies engaged in entertainment and music production

New York

- New York: Start-Up New York Program (“Start-Up NY”)
  - *Discretionary program to encourage businesses to create operations, expand within, or relocate to New York, beginning on or after January 1, 2014*
  - *Approved businesses locating in certain designated Tax-Free areas may receive exemptions from:*
    - Individual income tax for employees on earned income from the approved operations of the business;
    - Sales and use taxes;
    - Real property taxes;
    - Telecommunication services excise tax; and
    - Corporation Franchise Tax and various other business taxes
  - *There will be 68 Tax-Free areas, primarily in the upstate region*
    - There will be one tax-free area in each borough of New York City as well as a small number of tax-free areas in Long Island and Westchester
  - *Both existing New York businesses and businesses new to New York can apply*

New York

- Tax Incentives for Solar Energy System Equipment
  - SB 3203 provides a sales tax exemption for the installation and purchase of solar energy systems for commercial properties
  - AB 10620 extends New York City's real property tax abatement for solar equipment placed in service on or after Jan. 1, 2013 and before Jan. 1, 2015
    - Includes residential, commercial, and industrial properties
    - Eligible taxpayers receive tax break of 2.5% of expenditures, the amount of taxes payable, or $62,500, whichever is less
- New York City Biotechnology Tax Credit
  - Period of eligibility extended from Dec. 31, 2012 to Dec. 31, 2015
  - Provides qualifying firms with a refundable credit for three types of expenses: acquisition of research and development property, employee training and other research and development expenses

New York

- Alternative Fuel Tax Incentives
  - SB 6259 extended the sunset date from Sept. 1, 2012 to Sept. 1, 2014 for the following incentives:
    - Clean energy enterprises eligibility for empire zone benefits
    - Alternative fuel vehicle refueling property corporation tax credit
    - Motor fuel tax exemption and refund for E85 ethanol, B20 biodiesel, and compressed natural gas or hydrogen fuel
    - Petroleum business tax exemption and reimbursement
    - Sales tax exemption for E85, CNG, and hydrogen fuel
  - Biofuel production credit is also extended from Jan. 1, 2013 to Jan. 1, 2020
- Commercial Advertisement Production Credit
  - The period of eligibility is extended to Dec. 31, 2014
  - Credit has $7 million total limit
  - $3 million is allocated to eligible production companies that film or record a qualified commercial outside of the metropolitan commuter transportation district

Texas

Texas

- The state of Texas passed two R&D related incentives
  - Effective January 1, 2014, taxpayers may claim a sales/use tax exemption for the purchase of tangible personal property used for R&D activities, or
  - Effective for reports due after January 1, 2014, taxpayers may claim a credit against franchise tax for qualifying research expenditures
- Franchise Tax R&D Credit - The amount of credit will be 5% of the difference between:
  - the qualified research expenses incurred in Texas during the period on which the report is based; and
  - 50% of the average amount of qualified research expenses incurred in Texas during the three tax periods immediately preceding the period on which the report is based
- Sales/Use Tax R&D Exemption - The sales/use tax exemption will apply 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

Utah

Utah: Economic Development Tax Increment Financing

- Post-performance, refundable tax credit for up to 30% of new state revenues (sales, corporate, and withholding taxes paid to the state) over the life of the project
- Eligibility
  - Available to companies looking to relocate or expand operations to Utah
  - Urban communities: At least 50 new jobs paying at least 125% above urban county average wage and be in a target industry
  - Rural communities: New jobs created must pay at least 100% of rural county average wage
  - Significant capital investment and purchases from Utah vendors of suppliers
  - Retail operations are ineligible
  - Beginning September 2015, health benefits can no longer be used to calculate average wage
- Administrative requirements
  - Commitment from local government to develop an Economic Development Zone and provide local incentives
  - Incentive agreement with Governor's Office of Economic Development specifying performance requirements

Agenda: State and Local Tax Considerations

State Nexus Considerations

State Apportionment

Recent Legislative Updates

Amnesty Programs

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)

State Tax – Nexus Issues – Telecommuter Nexus

Colorado Telecommuter General Information Letter (GIL-13-024)

- An out-of-state accounting firm with an employee (a non-resident of Colorado) working remotely in Colorado, has nexus in the state
- Colorado DOR determined that residency of employees is not relevant to determine whether the costs associated with performing a service are in the state
- As such the firm must allocate income to Colorado based on where the cost to perform the service is incurred

Telebright v. Director, Division of Taxation, No. A-5096-09T2, 424 N.J. Super 384 (App. Div. 2012), affirming 25 N.J. Tax 333 (2010)

- Corporation having an employee who works remotely from their NJ home was considered doing business in New Jersey
- The corporation must file New Jersey Corporation Business Tax returns

State Tax – Nexus Issues – Telecommuter Nexus

In the Matter of the Appeal of: Warwick McKinley, Inc., No. 489090, 2012 Cal. Tax 14 (2012)

- Recruiting services corporation in Massachusetts allowed one employee to work from home in California
- One employee gave nexus, because enabled the corporation to “generate business”
- Test : Whether taxpayer received substantial benefits from the state

H.R. 2992 – Business Activity Tax Simplification Act of 2013

Identical to H.R. 1439, which left Committee and reached the House of Representatives, but was never voted on.

- Would expand PL 86-272 to service providers and sellers of intangibles
- Would expand PL 86-272 to include Business Activity Taxes
- Would require **physical presence** in state
  - *Non-protected activities in state for **15 or more days***
  - *Property in state for more than 15 or more days*
  - *Having an agent in the state for 15 or more days*
- Partners have nexus in the state if Partnership has nexus in the state
- Heard by Subcommittee on Regulatory Reform, Commercial and Antitrust Law on February 26, 2014
- The Bill has not moved out of committee

Factor-based Nexus Standards

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

- California
- Colorado
- Connecticut
- New York State (2015)
- Ohio (CAT)
- Tennessee (2016)
- Washington (B&O Tax)

Multistate Tax 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

The formula used to determine the portion of a business's income that is attributable to activities within the state.

The three common apportionment ratios that make up the overall apportionment factor are:

- Property
- Payroll
- Sales

Current trend: Extra weighting of the sales factor

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

Sales Factor Sourcing

Trends

States are more heavily weighting sales factor, including moving to 100% sales factor Number of states with equal-weighted three factor formula continues to diminish.

Cost of performance rules and the interpretation of those rules often varies from state to state in the following areas -

- Third party costs
- Indirect costs
- 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

Sales Factor Trends
Cost of Performance

The general rule:

- Sales, other than sales of tangible personal property, are in this State if:
  - *(a) the income-producing activity is performed in this State; or*
  - *(b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on cost of performance. (UDITPA, Article IV, Section 17)*
- "Cost of Performance" – No Bright Line Test
- Typically, taxpayer's costs as determined in a manner consistent with GAAP or the taxpayer's trade or business

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 arguable 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-Sourcing
Multistate Tax Commission Update

On July 30, 2014, the MTC formally adopted revisions to Article IV of the Multistate Tax Compact

- Market-based sourcing for receipts from services and intangibles
- Receipts from services sourced to a particular state if the service is delivered to a location in the state
- Throwout rule

Market-Based Sales Sourcing

State 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)

Throw-Out Rule

Throw-out rule – receipts are excluded from the denominator of the sales factor, if taxpayer is "not taxable" in state where service is received

"Not taxable" in state where service is received may be defined differently in each state

- Sales to clients in foreign jurisdictions
- Filing requirement

Alabama, Illinois and Massachusetts have adopted throw-out rules for receipts from services

State Apportionment
Wisconsin Reminder

Murphy v. Wisconsin Dep't of Rev., No. 09-I-134, (Tax Appeals Commission, Dec. 30 2010)

- In Wisconsin, normal business apportionment rules do not apply to personal service income
- Instead, special rule, which requires each partner to determine hours worked in Wisconsin
- Partners receiving personal service income from partnership are not subject to Wisconsin tax, unless they perform services in Wisconsin

Recent Legislative Updates: Tennessee, New York State, New York City

Tennessee Revenue Modernization Act (“RMA”)

The TN General Assembly passed the Revenue Modernization Act, H.B. 644, on April 22, 2015

Signed by Governor on May 20, 2015

Goals of RMA

- Update the tax laws to better address the changes in technology and modern business practices
- Level the playing field for in-state and out-of-state businesses
- Conform with other states that have already changed laws to address modern business practices

Revenue Modernization Act

The RMA includes the following modifications to Tennessee law:

- Adopts economic nexus thresholds for the business tax and the franchise and excise tax
- Replaces the existing apportionment double-weighted sales factor with a triple-weighted sales factor for calculating the franchise and excise tax
- Amends the excise tax deduction for intangible expenses paid to an affiliate
- Adopts market-based sourcing for sales other than the sale of tangible personal property
- Adds an elective apportionment calculation for high-volume sellers with distribution centers in Tennessee
- Expands sales tax to include remotely accessed software
- Adds a presumption of "click-through" nexus for sales and use tax purposes for certain dealers

Economic Nexus

Enacted economic nexus standards apply to both business taxes and franchise and excise taxes.

Substantial nexus in the state means:

- Organized or commercially domiciled in the state;
- Owns or uses capital in the state;
- Systematic and continuous business activity in the state that produced gross receipts attributable to customers in the state;
- Licenses intangible property for use by another party and derives income from that use in the state; or
- Bright-line presence in the state.

Effective for tax years beginning on or after January 1, 2016

Economic Nexus (Continued)

Bright-line presence means:

- Receipts in the state exceed the lesser of $500,000 or 25% of total receipts everywhere;
- Average value of real and tangible personal property owned or rented and used in the state exceeds the lesser of $50,000 or 25% of the average value of real and tangible personal property everywhere; or
- Compensation paid in the state exceeds the lesser of $50,000 or 25% of the compensation paid everywhere.

Companies treated as foreign corporations for federal tax purposes that have no effectively connected income in the United States shall not be considered to have substantial nexus for Tennessee income and franchise tax purposes.

Market-Based Sourcing

RMA replaces the current cost-of-performance method for sourcing sales other than the sales of tangible personal property with a market-based sourcing approach.

Under market-based sourcing, receipts from sales, other than from the sale of tangible personal property, are in the state if and to the extent the taxpayer's market for the sale is in the state.

Applies to franchise and excise tax

Effective for tax years beginning on or after July 1, 2016

Market-Based Sourcing (Continued)

The taxpayer's market for a sale is in the state if:

- Sale relates to real property located in TN
- Sale relates to tangible personal property located in TN
- Sale relates to intangible property used in TN, or
- Sale relates to services delivered to location in TN
- If location is not determinable, then a reasonable approximation should be used. Otherwise the sale is thrown out of the factor entirely.

The RMA does not define "market", but the Department is expected to promulgate rules before the law change goes into effect clarifying this issue.

New York 2015-16 Legislation

New York Legislature Passes Bills Amending State Tax Law

- On April 1, 2015, the New York State Legislature delivered to New York's Governor Andrew Cuomo for signature the 2015-2016 state budget bills
- Governor Cuomo signed the budget bills on April 13, 2015
- This legislation made technical corrections and other revisions to the New York State tax reform provisions enacted in 2014

NYS 2015-16 Tax Legislation

Clarifying that only unitary group members that meet the ownership test under Article 9-A (more than 50% voting power ownership) are considered in applying the aggregate bright-line economic nexus tests.

Excludes from the application of the bright-line economic nexus test corporations that are not permitted to be included in a combined report under Article 9-A that otherwise could be considered unitary (e.g., corporations taxed under Article 9 or Article 33)

Eliminating the requirement that the designated agent of a combined group, a taxpayer which acts on behalf of the members of the group relating to the combined report, must be the parent corporation

Clarifying that the commonly owned group election (permitting qualifying nonunitary groups to file a combined return) is made on a timely filed return of the combined group, determined with regard to extensions

NYS 2015-16 Tax Legislation Investment Capital Re-defined

Two categories of exempt investment income:

- Income that cannot be apportioned because it is from assets not used in a trade or business
- Stock held for more than 6 months.

“Technical corrections” redefine second category to include:

- Stock that meets definition of capital asset under IRC 1221 at all times owned by the taxpayer.
- Held by taxpayer for investment for one year.
- Disposition would generate long term capital gain/loss (i.e., conformity to federal rules for determining holding period)
- Has never been held for sale to customers
- On day of acquisition clearly identified in taxpayer’s records as held for investment similar to IRC sec. 1236 requirements for dealers.
- Removed QFI limitation
- Hedges of investment capital no longer automatically produce investment income.

NYS 2015-16 Tax Legislation
Investment Income Limitation

Gross investment income (i.e., prior to subtracting attributable interest expense) limited to 8% of entire net income.

- 40% safe harbor election would be applied after application of 8% limitation.
- This limitation appears to reflect concern over abuse of investment income rules
- Clarifies that 40% safe harbor election is a revocable election.

This limitation raises both policy and constitutional issues

- Does it apply to non-headquartered corporations?
- Does it provide an incentive for corporations with significant investment income to move headquarters outside NY?

NYS 2015-16 Tax Legislation
NOL refinements

Clarifies that the election to use PNOL’s over two years is a revocable election

Clarifies that, if the election is made, any unused PNOL’s are forfeited.

Clarifies that if election is not made, NOL’s are carried forward for 20 “taxable” years or the taxable year beginning in 2035, whichever is first.

Clarifies carryback and carryforward procedure for ordinary NOL’s and provides for election to forego carryback.

NYS investment tax credit

Budget reinstates 10/1/15 sunset date for credit along with aggregation rule inadvertently deleted in corporate tax reform.

New York Legislature Passes Bills Amending New York City Tax Law

On April 1, 2015, the New York State Legislature delivered to New York's Governor Andrew Cuomo for signature the 2015-2016 New York City budget bills

Governor Cuomo signed the budget bills on April 13, 2015

This legislation enacted broad-based tax reform of the New York City corporate tax regime that is generally consistent with the New York State tax reform provisions effective for tax years beginning on or after January 1, 2015

NYS 2015-16 Tax Legislation
NYC Tax Reform

NYC is conforming with the NYS tax reform as amended effective January 1, 2015, with the following exceptions:

Conformity does not apply to S Corporations and entities subject to unincorporated business tax.

Alternative income bases not eliminated

Phase out of 3 factor formula continues based on previous GCT provisions. One-time election to preserve small payroll and property factors after 2017.

No economic nexus provisions other than for credit card issuers

New deduction for interest income from qualified affordable housing and low income community loans.

NYS 2015-16 Tax Legislation
NYC Tax Reform

Limited tax rate reduction

- 6.5% rate for non-manufacturers with pre-apportioned and post apportioned business income below certain thresholds.

No phase out of capital tax – Cap on capital tax increased to $10 million.

NYS 2015-16 Tax Legislation
NYC Tax Reform

Reporting state changes

- Currently no assessment can be made with respect to changes to the allocation of income or capital after the regular statute of limitations expires.
- The legislation provides an exception where the assessment is based on a NYS change.
- The rule also applies to refunds.

NYS 2015-16 Tax Legislation
NYC Tax Reform

Adopting a limited economic nexus concept that provides that a corporation is doing business in New York City if it has:

- *“customer nexus”*
- *“contract nexus”*
- *Or sum of both customers and contracts giving rise to nexus equals 1,000 or more*

Adopting general customer-based (market) sourcing of receipts and specific sourcing rules for digital products and financial service receipts

Maintains the scheduled phase-in of single sales factor apportionment by 2018

- *One-time election (with 2018 taxable year return) for taxpayers/combined groups with $50 million or less of New York City receipts to retain the 2017 apportionment factor weighting*

Amnesty Programs

Amnesty Programs

Current Programs

- Arizona – Beginning September 1, 2015 through October 31, 2015
- Maryland – Beginning September 1, 2015 through October 30, 2015
- Missouri – Beginning September 1, 2015 through November 30, 2015
- Oklahoma – Beginning September 14, 2015 through November 30, 2015
- Puerto Rico – Ending June 30, 2015

Upcoming Programs

- Indiana – Beginning January 1, 2016

Recent Programs

- Massachusetts – Began March 16, 2015 and ended May 15, 2015
- Louisiana – Ended November 14, 2014
  - *After 2015, Louisiana will not implement another amnesty program before January 1, 2025*

Contacts

Laura Ray

Tax Partner
Deloitte Tax LLP, Chicago Office
312-486-1807
laray@deloitte.com

Greg Rottjakob

Tax Partner
Deloitte Tax LLP, St. Louis Office
314-342-1856
grottjakob@deloitte.com

Jenny Voorhees

Tax Senior Manager
Deloitte Tax LLP, Chicago Office
312-486-2189
jvoorhees@deloitte.com

Elizabeth E. Kuck

Tax Senior Manger
Deloitte Tax LLP, Chicago Office
312-486-4193
ekuck@deloitte.com

Michael Locascio

Tax Director
Deloitte Tax LLP, San Francisco Office
415-783-6041
mlocascio@deloitte.com

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