Aerospace and defense tax outlook
The Dbriefs Aerospace & Defense series
Troy Watkinson, Partner, Deloitte Tax LLP
Dan Bowman, Senior Manager, Deloitte Tax LLP
Brian Drujak, Senior Manager, Deloitte Tax LLP
Justin Fineberg, Senior Manager, Deloitte Tax LLP
May 11, 2017
Federal R&D tax credit developments
Polling question #1

Have you previously researched or had discussions regarding the application of final Treasury Regulations related to software development expenses to your firm?

• Yes, we’ve researched internally or discussed and believe them to have potential application.

• Yes, we’ve researched or discussed and do not believe them to have potential application.

• No, we have not considered and have not had any discussions regarding the potential application of these regulations.

• We were not aware that new regulations were issued under IRC Section 41.

• Not applicable
Section 41—R&D tax credit developments
Final regulations governing software development expenses

Treasury Department issued final regulations in October 2016 providing rules identifying software development project that qualify for the R&D tax credit

• In general, the Section 41(d)(4)(E) restricts and limits “Internal Use Software” (“IUS”) from being eligible for R&D credit

• Final regulations define IUS and clarify credit requirements
  − Research with respect to IUS is eligible for the research credit if it:
    ◦ Meets Section 41(d) requirements;
    ◦ not excluded under Section 41(d)(4); and
    ◦ Satisfies the “high threshold of innovation test”
  − Clarifies that software is not IUS if, at the beginning of IUS development, it is:
    ◦ not developed for use in G&A functions that support taxpayer’s business and
    ◦ developed to be commercially sold, leased, licensed, or otherwise marketed to third parties, or enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on taxpayer’s system.
Dual Function Software—
Software developed both for use in G&A functions and enable a taxpayer to interact with third parties or allows third parties to initiate functions or review data is presumed to be developed for internal use.

- Presumption inapplicable if taxpayer can identify a subset of elements that only enables third party interaction ("third party subset")
  - Portion allocable to third party subset, may be eligible for R&D Credit
  - Safe harbor rule allows 25% of the QREs of dual function subset to be eligible for R&D Credit if third party interaction is anticipated to be at least 10% of use

Highly Threshold of Innovation—
IUS may otherwise be credit eligible if it satisfies a three-part high threshold of innovation test:

- The software is “innovative” in that it results in reduced costs, improved speed or other measurable improvements that are substantial and economically significant
- Development has significant economic risks and substantial uncertainty
- Software is not commercially available for use
Recent Developments—Internal Use Software (IUS)—A&D Industry

Software Development Activities in the Aerospace & Defense Industry may Benefit from the New Regulations that has clear definitions for IUS.

Prior Guidance

- **G&A Functions**
  - **Internal use**
  - **Third Parties**
- **Sale, Lease, or License**
  - **Not internal use**

Guidance as Per New Regulations

- **G&A Functions**
  - **Internal use**
  - **Dual function**
  - **Third Parties**
- **Sale, Lease, or License**
  - **Not internal use**
Section 41 – R&D tax credit developments
Treas. Reg. 1.41-4(c)(6)(viii) examples

Ex. 7—Not IUS because of third party interaction
• A manufacturer develops software for a website with intent to allow third parties to access data on manufacturers database, to order products and track status of orders.

Ex. 11—Dual function software and identification of third party subset
• taxpayer develops software for use in G&A function that facilitate or support the conduct of its trade or business and to allow third parties to initiate functions. Taxpayer is able to identify an allocate amounts to a third party subset. If amounts constitute qualified research under section 41(d) and are QREs under section 41(b), then amounts may be eligible for the R&D credit.
Section 41 – R&D tax credit developments
Treas. Reg. 1.41-4(c)(6)(viii) examples

Ex. 15—Application of high threshold of innovation test.

Taxpayer maintained separate software for tracking various HR functions. Taxpayer determined improved HR efficiency could be achieved by redesigning its disparate software applications into one system. There is not a commercially available database management system suitable. If successful, taxpayer would experience reduced costs and improvement in speed that is substantial and economically significant. Taxpayer committed substantial resources but could not predict, because of technical risk, whether it could develop the software in the timeframe necessary to recover its resources within a reasonable period.
State corporate tax developments
A new Virginia R&D tax credit pool exists for tax years beginning January 1, 2016.

- Non-refundable credit for taxpayers with more than $5 million in qualified research expenses ("QRE") ("Major Research and Development Tax Credit")
  - Credit pool: $20 million
  - Unused credit carryforward: 10 years
- Refundable credit for taxpayers with less than $5 million in QRE.
  - Credit pool: $7 million
  - Credit cap: available credit per taxpayer has increased to $45,000
- Application deadline: July 1, 2017
State corporate tax developments
D.C.—Qualified high technology company developments

Recent legislative and regulatory changes, as well as the implications resulting from litigation have narrowed the ability of companies to claim eligibility under D.C.’s Qualified High Technology Company (“QHTC”) program.

• QHTC background, eligibility, and tax benefits
• QHTC legislative and judicial evolution
  – 2012 Enhancement Act
  – Fiscal Year 2015 Budget Support Act of 2014
  – Recent D.C. Court of Appeals decision
Polling question #2

How long has your company taken advantage of the tax benefits provided under the D.C. QHTC program?

• Since the program’s inception
• Less than 2 years
• More than 5 years
• My company has never analyzed whether any of the entities within our structure could qualify as a QHTC
State corporate tax developments
D.C.—Corporate franchise tax developments

D.C.’s Fiscal Year 2015 Budget Support Act of 2014 included tax rate reductions for businesses that would take effect on a cascading basis, ultimately reducing the tax rate to 8.25%, subject to available funding.

• For tax years beginning on or after 12/31/2016, rate reduction from 9.2% to 9.0%.

• Additional rate reduction from 9.0% to 8.25% for tax years beginning on or after 12/31/2017.
  ◦ Potential Q1 2017 financial statement impact for calendar year taxpayers.

For tax years beginning after 12/31/2014, D.C. implements a single sales factor with market-based sourcing for sales other than sales of tangible personal property.
State corporate tax developments
Data Centers—Indirect tax incentives

Some states provide an exemption for computer equipment purchased for use at a qualifying data center.

• To qualify for the exemption, a capital investment threshold must often be met.
• Once the data center is qualified, tenants and subtenants can often benefit from sales tax exemptions for equipment purchased for use at a qualifying data center.
  − Potential refund opportunities and prospective benefit on future purchases.
• Georgia, North Carolina, New York, Texas, Virginia, and Washington are examples of states that provide an exemption.
Revenue recognition developments
Polling question #3

Do you plan to early-adopt ASU 2014–09?

• Yes
• No
• Still assessing
GAAP revenue recognition changes coming soon

Background

On May 28, 2014, the FASB and IASB issued ASU 2014-09 by the FASB and as IFRS 15 by the IASB (codified as ASC 606, Revenue from Contracts with Customers), which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.

The goals of the revenue recognition project are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing “a more robust framework for addressing revenue issues.”

Effective Date:

- Annual reporting periods beginning after December 15, 2017 (public)
- Annual reporting periods beginning after December 15, 2018 (nonpublic)
- Early adoption of ASC 606 permitted for annual reporting periods beginning after 12/15/16
Common misconceptions

I don’t expect the GAAP changes to be significant.

The tax impacts will be timing only.

The changes made to GAAP will not impact my tax calculation as I can just follow book for tax.

I don’t need to start now because the changes are not effective until 2018/2019.

There are new GAAP revenue recognition standards?

The tax impacts will be compliance only.
New revenue guidance
The five-step model

**Core principle:** Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services.

1. **Identify the contract with a customer (Step 1)**
2. **Identify the performance obligations in the contract (Step 2)**
3. **Determine the transaction price (Step 3)**
4. **Allocate the transaction price to performance obligations (Step 4)**
5. **Recognize revenue when (or as) the entity satisfies a performance obligation (Step 5)**

This revenue recognition model is based on a control approach, which differs from the risks and rewards approach applied under current U.S. GAAP.
New revenue guidance
The five-step model—A&D considerations

- FCS Contracts
- Unpriced change order
- Undefinitized Contract
- Unfunded amounts

Identify the contract with a customer (Step 1)

Identify the performance obligations in the contract (Step 2)

Determine the transaction price (Step 3)

Allocate the transaction price to performance obligations (Step 4)

Allocate the transaction price to performance obligations (Step 5)

- Award fees
- Incentive fees

- Fixed & Determinable
- Special PoC considerations

- Renewal options
- IDIQ – Variable options and consideration

- Form of Contract and Contract Price
- Engineering & Design vs Production

Recognize revenue when (or as) the entity satisfies a performance obligation (Step 5)
Polling question #4

To the extent you have begun analyzing the tax impacts of adoption of the revenue recognition standards, have you identified issues or opportunities in addition to the timing of revenue recognition?

• Yes, we’ve identified other tax implications

• No, we haven’t completed our analysis of the impact of the standard

• No, we have completed our analysis and haven’t identified other tax implications
### Common tax considerations and anticipated action items

<table>
<thead>
<tr>
<th>Area</th>
<th>Common Tax Considerations</th>
<th>Anticipated Action Items</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GAAP Revenue Recognition</strong></td>
<td>• Current types of revenue streams and related GAAP treatment</td>
<td>• Opportunity to leverage financial statement revenue stream analysis to proactively generate additional cash and fund project implementation costs</td>
</tr>
<tr>
<td></td>
<td>• Assess how the GAAP change in method of accounting under the new standards for each of the various revenue streams will impact the current tax method</td>
<td></td>
</tr>
<tr>
<td><strong>Tax Provision</strong></td>
<td>• Any changes to tax accounting methods or book tax difference computations must be incorporated into the tax provision process</td>
<td>• Computation and tracking of new or altered book-tax differences</td>
</tr>
<tr>
<td></td>
<td>• Consideration should be given to the correct period to reflect the change</td>
<td></td>
</tr>
<tr>
<td><strong>Tax Data and Process; Systems</strong></td>
<td>• Systems will need to be evaluated to confirm that the software solutions used by accounting will provide the necessary data for tax analysis</td>
<td>• Reconciliation of the book restatement with tax’s lack thereof and associated tracking considerations</td>
</tr>
<tr>
<td></td>
<td>• Identify additional data needed to support tax accounting</td>
<td></td>
</tr>
</tbody>
</table>
### Common tax considerations and anticipated action items (cont.)

<table>
<thead>
<tr>
<th>Area</th>
<th>Common Tax Considerations</th>
<th>Anticipated Action Items</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Indirect and Multistate Tax</strong></td>
<td>- Sales tax, VAT, telecom taxes, fuel taxes, etc.</td>
<td>- Opportunity to leverage financial statement revenue stream analysis to proactively generate additional cash and fund project implementation costs</td>
</tr>
<tr>
<td></td>
<td>- Impact to indirect tax varies greatly by industry and type of taxes imposed.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Impacts generally expected in areas where the basis of tax is book revenue or where the tax base is not well defined</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Changes to the basis of tax could impact the amount of tax reported as well as collections. In some instances, there may be a disconnect between the basis on which a company collects and the base on which it remits to the taxing authorities (e.g., telecom taxes imposed on book revenue but collected on billings to the customer which may not change due to the adoption process)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Many tax types are based upon billed revenues, which underlies the importance of reducing changes to the billing systems</td>
<td></td>
</tr>
<tr>
<td><strong>Global Tax Implications</strong></td>
<td>- Any changes to the statutory financial statements can potentially impact tax measures based upon the financial statements, such as: thin capitalization limits, distributable reserves and transfer pricing</td>
<td>- Computation and tracking of new or altered book-tax differences</td>
</tr>
<tr>
<td></td>
<td>- Since both IFRS and US GAAP are changing, cash taxes may be impacted in local countries due to changes in statutory financial statements. For jurisdictions similar to the US, tax methods may need to be reviewed. For jurisdictions where the statutory filings form the basis of tax with few modifications, cash taxes paid to the jurisdiction may be impacted</td>
<td></td>
</tr>
</tbody>
</table>
Question and answer
Join us May 18 at 11 a.m. ET as our Travel, Hospitality & Leisure series presents:

Serving up the right CX: Restaurant customer experience strategy and implementation
Eligible viewers may now download CPE certificates.

Click the CPE icon in the dock at the bottom of your screen.
Contact information

Troy Watkinson
Partner
Deloitte Tax LLP
twatkinson@deloitte.com
LinkedIn

Dan Bowman
Senior Manager
Deloitte Tax LLP
dabowman@deloitte.com
LinkedIn

Brian Drujak
Senior Manager
Deloitte Tax LLP
bdrujak@deloitte.com
LinkedIn

Justin Fineberg
Senior Manager
Deloitte Tax LLP
jfineberg@deloitte.com
LinkedIn
This presentation contains general information only and Deloitte is not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this presentation.