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Tax Reform Considerations for Engineering and Construction Companies

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As prior experience has shown, changes in the tax law can have significant implications for specific industries. The engineering and construction ("E&C") industry is no exception and the current tax reform proposals may have a more meaningful impact than anything since 1986. Further, the bipartisan agreement between Congress and the administration to fund improvement to the country's infrastructure is expected to drive growth in the industry and has been reflected in stock prices. Tax reform proposals need to be considered before sourcing services and materials and raising capital as new contracts are being proposed and negotiated.

Although a number of tax reform proposals have been formulated and discussed in recent years, the one that is the subject of most current discussion is referred to as the House Republican "Blueprint."[1] The Blueprint is a high level, conceptual document that was released by House Republicans last June; no statutory language has been proposed or released. The discussion below addresses a number of issues raised by the Blueprint that could be highly relevant to the E&C industry if tax reform based on the Blueprint ultimately were enacted. Further, we address the potential financial statement impact, and actions that E&C companies may consider to mitigate adverse or to optimize favorable outcomes of possible enactment.

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1 *A Better Way—Our Vision for a Confident America*, (June 24, 2016) (a document referred to as the "Blueprint" published by the House of Representatives Republican Tax Reform Task Force).

What Is Proposed?

There are a lot of details in the Blueprint. But, generally, we can summarize the major proposals as follows:

- Lower the corporate rate—The Blueprint suggests 20 percent for corporations
- Expense capital expenditures—All capital expenditures including tangible and intangible assets, except land would be immediately deductible
- Eliminate interest deductions—Only deduct interest expense to the extent of interest income, the excess of which would carry forward indefinitely
- Net operating losses ("NOLs") would have an indefinite carryforward period—limited to 90 percent of taxable income each year, no carryback
- Deemed repatriation of all unrepatriated earnings and profits ("E&P")—Tax at reduced rate of 8.75 percent on cash and cash equivalents and 3.5 percent otherwise, to be paid over eight years
- Destination-based or border adjustable tax system—Goods and services would be taxed based on where they are consumed: Exports would not be taxed in the United States; imports would not be deductible in the United States
    - This eliminates the taxation of worldwide income and transforms to a territorial tax system
    - All dividends from foreign subsidiaries and remittances from foreign branches would be exempt
- Repeal most tax "expenditures"—section 199,[2] statutory depletion, and similar incentive provisions would be gone, excepting the research credit and last-in, first out ("LIFO")
- Repeal alternative minimum tax ("AMT")

The design is intended to convert the present worldwide income tax system to a territorial consumption-based tax. It is similar economically to a value added tax, but largely relies on the current tax infrastructure to administer and collect the tax.

[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

What Is of Particular Importance to the E&C Industry?

Most E&C companies are not highly leveraged and are not capital intensive. But, they buy and sell globally, many have accumulated earnings offshore, and everyone is affected by a reduction of the tax rates. So, there are three areas that we will focus this discussion on:

- Tax rate reduction,
- Deemed repatriation, and
- Border adjustable tax system

Below is a discussion of the potential impacts on your cash taxes, transfer pricing, and accounting for income taxes.

Tax Rates

The Blueprint proposes a flat 20 percent corporate tax rate (25 percent for business income earned by pass-through entities and sole-proprietorships that are taxed at the individual level, backstopped by a reasonable compensation standard.) Also, the individual tax rates are to be reduced.

The impact of a change in the statutory rate on income taxes has several rippling effects.

- From an accounting for income taxes perspective, you must, among other things, remeasure deferred taxes related to temporary differences at the new statutory rate;
- The rate for cash taxes would improve (absent the impact of other provisions); and
- The jurisdiction becomes more attractive to locate your value-driving and exporting activities, and so your transfer pricing and supply chain strategy may need revisiting.

We will explore these issues further in the discussion below.

Deemed Repatriation

As previously mentioned, the Blueprint intends to move the United States to a territorial tax system and away from the "existing outdated worldwide tax system." In addition to the border adjustability discussed below, a key aspect of a territorial based tax system is to provide for a full exemption for dividends and remittances received from foreign subsidiaries and foreign branches. As part of the move to the territorial approach to international taxation, the Blueprint will provide rules that will tax currently unrepatriated earnings to "allow foreign earnings that have accumulated overseas under the old system to be brought home." The Blueprint goes on to state that the move to a dividend exemption system will "eliminate the 'lock-out effect' of current law" and "will free up more than $2 trillion in foreign earnings" that have been "stranded" overseas. As such, the current taxation on unremitted earnings, referred to as deemed repatriation, is considered a necessary transition rule moving toward a territorial taxation system.

The Blueprint offers minimal guidance regarding the mechanism in which the deemed repatriation tax will be determined. The Blueprint simply states that accumulated foreign earnings will be subject to tax at 8.75 percent to the extent held in cash or cash equivalents, all other earnings will be subject to tax at 3.5 percent. Further the Blueprint would allow companies to pay the resulting tax liability over an eight-year period. The repatriation regime proposed by the Tax Reform Act of 2014 could be a model for the potential operation of the Blueprint.

Destination-Based Territorial Tax System

The United States currently operates under a worldwide tax regime under which U.S. taxpayers are taxable on their worldwide earnings, but are permitted a credit, subject to certain limitations, for taxes paid to foreign jurisdictions. In general, non-U.S. taxpayers are subject to tax on income that is "effectively connected" with a trade or business conducted within the United States (or under an applicable tax treaty with respect to income attributable to a permanent establishment within the United States) and with respect to passive FDAP (fixed, determinable, annual and periodic) income from sources within the United States, such as dividends, rents, and interest. Under current law, a non-U.S. person's sale of U.S. real estate is deemed to be "effectively connected" under the FIRPTA rules.

The Blueprint describes an entirely new, and radically different, international tax system:

> Under a destination-basis approach, tax jurisdiction follows the location of consumption rather than the location of production. This Blueprint achieves this by providing for border adjustments exempting exports and taxing imports, not through the addition of a new tax but within the context of the transformed business tax system. The Blueprint also ends the uncompetitive worldwide tax approach of the United States, replacing it with a territorial tax system that is consistent with the approach used by our major trading partners. These two fundamental structural changes in turn allow other important aspects of the international tax rules to be simplified and streamlined significantly.

The Blueprint description outlines broad concepts, but does not provide adequate detail to allow one to confidently determine how those concepts would play out in all situations. As a threshold matter, the Blueprint's border adjusted, destination-based system appears to apply to all business income, but as noted above, with different rates for sole proprietorships and pass-through business entities, as opposed to corporations.

Under this new business tax, it appears that transactions would be taken into account only if the counterparty is a U.S. taxpayer. Accordingly, income received from customers that are U.S. taxpayers would be taken into account, but expenses (consumption) paid to non-U.S. taxpayers would not. It would appear that, in a typical scenario, a U.S. business purchase of subcontractor services performed in a foreign country would not be deductible. The result is that 100 percent of the revenue from such goods within the United States would be subject to tax without any reduction for the cost of the sale.

Correspondingly, a U.S. business that purchases services or property for use in its business, or for resale, from a non-U.S. seller would be unable to recover these costs through expensing or offset in a

gain computation. Such a result obviously could be significant for E&C companies in determining how they procure engineering services, procure construction materials, and even contract with customers. For example, a direct purchase of Italian marble from Italy could result in the denial of any cost recovery for this portion of the capital expenditures incurred in the construction of a building.

With respect to non-U.S. persons, one gating issue regarding their taxation is determining when they became U.S. taxpayers, which is tied to the U.S. trade or business standard. It is unclear whether or how the U.S. trade or business standard will change through tax reform and, as a related point, in what contexts rules similar to the current FDAP rules might be applied. Similarly, income for engineering or construction management services provided overseas with respect to the off-shore projects would seem not to be subject to U.S. tax. There would be no crediting of non-U.S. taxes under such a regime, so payment of taxes in foreign jurisdictions would appear to be irrelevant to the calculation of U.S. tax liability.

Clearly the border adjusted tax system will need to be considered in contacts currently being proposed and negotiated. For materials and services to be sourced offshore, you should consider splitting the contracts so the customer contracts for the goods and services directly from the foreign vendor, even if it is related.

Whether the U.S. taxpayer will avoid paying any tax for overseas contracts for the U.S. government would seem to contradict established policy, although this is not addressed in the Blueprint.

Transfer Pricing in the Context of Tax Reform: Key Attributes of E&C Companies

Although it is not mentioned in any provision of the Blueprint, the move to a destination-based tax system will put pressure on existing transfer-pricing regimes. As discussed above, the result of a border adjusted tax, if implemented without exceptions, would be that exports (including intercompany sales) from products, services or licensing of intellectual property would not be subject to U.S. federal income tax. Similarly, the cost of imports of goods, services, and royalty payments would be disallowed as a deduction in computing U.S. federal income subject to tax. Thus, transfer pricing would be irrelevant to determination of U.S. taxable income.

Unless foreign jurisdictions enact similar tax provisions in their respective countries, transfer pricing will continue to be of interest for local country tax compliance outside of the United States. In fact, one might expect enhanced scrutiny of intercompany transactions with the United States by the foreign tax authorities.

It does seem plausible that Advance Pricing Agreements and similar arrangements involving the United States would lose relevance since transfer pricing will not affect U.S. federal Income tax. Some transfer pricing professionals think that the importance may actually increase in light of the point above. However, the nature of U.S. competent authority assistance might change. While we believe that U.S. competent authority would retain legal authority under U.S. law, the United States would not have any “skin in the game.” This will need to be considered in any treaty negotiations.

Most multinational corporations including E&C companies have complex supply chains. In addition, E&C companies generally have supply chains that are probably more fluid to allow for flexibility to successfully penetrate global markets and derive a considerable portion of their overall revenue from customers located overseas.

Economists have argued that over time the currency markets will likely move, and the dollar strengthen, to response to the border adjusted tax. Similarly, the labor market in the United States is already tight for skilled workers. Increased demand for U.S. labor will likely raise wage rates and therefore increased cost of labor. In addition, reaction of foreign governments will also be important. From a value chain management perspective, the optimal value chain when the U.S. rate is 35 percent with deferral vs. 20 percent with a territorial system and border adjustment is clearly different. It becomes an apparent trade-off between (1) higher wage U.S. labor and zero export tax; and (2) lower wage labor in certain locations and higher tax. The potential implications and opportunities for E&C companies in a changing dynamic environment could be very significant. For instance:

- For U.S. projects (when the customer is a U.S. company), it appears plausible that there will likely be greater use of U.S. based resources. However, if the cost of U.S. labor increases in an already tight labor market and U.S. dollar gets stronger, it is very likely that use of non-U.S. labor from certain markets might actually increase, notwithstanding the tax impact. Transfer pricing considerations in the foreign countries continue to be relevant.

- Similarly, for non-U.S. projects, the incentive to use U.S. labor increases. As discussed above, the same economic factors will be in play in ultimately determining how the existing intercompany supply chain changes.

- Secondment arrangements will likely need to be re-evaluated. The current supply chain of most E&C companies allows for leveraging resources from a global pool depending on the availability and cost. Border adjusted tax creates an incentive for increased use of resources in the United States especially for non-U.S. projects.

- The use of domestic IP overseas would create a tax-exempt source of income. Examples include, royalties, and guarantee fees (either financial or performance).

Accounting for Income Taxes Implications

At present, since there has been no legislation, there has been no analysis to ascertain whether the tax regime proposed will continue to be accounted for as an income tax. But assuming that it is, E&C companies will have several issues to grapple with.

First, let's discuss the consequence of deemed repatriation. The existing assertions around investments in foreign subsidiaries (APB 23 exception) may require revisions as the assertion may not be supportable if taxation is required The charge associated with the repatriation, although spread over eight years, is accounted for as an income tax expense in the year of enactment. The total future income tax liability as of the date of enactment is reflected as a deferred tax liability; however, future

income tax benefits resulting in deferred tax assets may continue to be prohibited, unless they become apparent to reverse within the foreseeable future or otherwise offset taxation of other foreign earnings.

The computation of current income taxes will have added complexity as there will be new items impacting both permanent and temporary differences. The changes in permanent differences would be elimination of section 199 and other tax expenditures, and the net consequence of the border adjustments. Temporary differences arise from the disallowed interest deduction, full expensing of capital. The disallowed interest deduction may be carried forward indefinitely and will result in a related deferred tax asset; however, the deferred tax asset may require a valuation allowance if excess interest income to utilize the carryforward is unavailable.

As discussed earlier, deferred taxes on temporary differences must be revalued to account for the lower tax rate in the year of enactment. The impact of changes in tax law is reflected in U.S. GAAP financial statements in the interim period that includes the date of enactment and the entire impact of the change is reflected directly in income tax expense (benefit) from continuing operations. Taxpayers with net U.S. deferred tax liabilities will reflect an income tax benefit upon enactment while taxpayers with net deferred tax assets will reflect an income tax expense upon enactment. Without some transition rules, there are several other common deferred tax assets that could be written off, including AMT credits, foreign tax credits, and deferred interest charges; although some transition to permit utilization of some or all of the carryforwards may be incorporated into the final enacted tax law. Additionally, although the Blueprint is silent it is anticipated there will be a phase in period such that scheduling deferred taxes for tax rates and tax treatment will likely be a significant undertaking and would require an understanding of the period in which the temporary differences are anticipated to reverse.

The impact of all of this will need to be likewise considered in continuing to assess the enterprises unrecognized tax benefits and overall valuation allowance judgments.

Due to border adjustability, foreign sourcing of income can drastically change the tax posture of the enterprise and require a reassessment of valuation allowances. For example, those taxpayers that are net exporters of good and/or services may not be taxable. They may be unable to demonstrate the ability to recover NOLs, which would require them to establish a full valuation allowance. The fact that NOLs have an indefinite carryforward period will mitigate this issue, but not eliminate it.

On an ongoing basis, fully expensing capital expenditures will create temporary differences and deferred tax liabilities. Similarly with the border adjustments, as the taxpayer will have no basis in assets that are imported. Additional complexities may arise in the measurement of deferred tax assets and liabilities associated with border adjustability once additional information of implementation and execution becomes known.

Further, with a change to a cash-basis system, we will have a deferred balance related to payables, receivables, accruals, and deferrals.

Assessing the Impact on your Business

There are many divergent interests in the outcome of tax reform. Those business that are highly leveraged and large importers are dissuaded in spite of rate reduction. Business that are capital intensive and exporters are very interested. But, in fact, E&C companies can be on either side of the spectrum (winners or losers) depending on their individual "balance of trade." Those that sell significant services to overseas buyers may find themselves with no tax to pay. Those that utilize offshore engineering centers or procure a large proportion of materials may benefit little or none from lower rates without changing the nature of their business and/or contracts.

So, many board members, executives, and investors are asking about the impact of tax reform. Although it may be premature for some, informing stakeholders will help guide decision making about trying to influence the legislative outcome or planning to counter tax reform's possible effects.

Since the tax law changes the point of taxation to the place of consumption, there is a lot of data that is needed that has not typically been required for tax planning. Below is a sampling of details that must be provided on a cash method for each year by location of consumption—U.S. or foreign;

- Gross receipts
- Returns and allowances
- Cost of Sales
- All expenses
- Capital expenditures

Further, to compute the deemed repatriation you will need the amount of E&P that is in each controlled foreign corporation ("CFC") and the amount of cash held.

Also, you will need interest income, interest expense and NOL carryovers,

KPMG LLP has developed a model, based on the House Blueprint proposal that illustrates the effect that tax reform would have on your company. The model has been built to be customizable to meet your needs, including the ability to toggle off/on certain of the House Blueprint proposals. With an easy-to-read output, our model helps you analyze the most salient elements of tax reform:

- Displaying adjustments to the company's 2017-2021 tax returns,
- Comparing cash tax, cash tax rates, and net operating loss utilization with the current tax regime, and
- Estimating taxes due upon deemed repatriation.

Further, you can model the anticipated currency fluctuation to determine the overall impact to financial results.

Planning for Tax Reform

Since tax reform and the specific elements are unknown, we suggest that taxpayers take actions that might be otherwise beneficial or neutral in the current environment that will create benefits in the context of the proposed changes.

Maximizing the Benefit of Rate Reduction

In a low interest rate environment, taxpayers have looked at planning that effected the timing of items of little value without a very long-term tax deferral. Taxpayers ordinarily engage in tax accounting method planning to accelerate cash tax benefits involving temporary items, such as revenue deferral, expense acceleration, inventories, capitalization and depreciation for fixed assets, and amortization of intangibles. Moving income or expense items into different periods generally has no permanent effect on income tax expense (benefit) within the financial statements when the statutory tax rate is constant. However, in periods in which the tax rate changes, accounting methods planning should not be viewed solely as a prospective change under which a taxpayer will pay less tax in future years. In that case, accounting methods planning may provide an opportunity for a taxpayer to achieve a permanent tax benefit through the acceleration or deceleration of deductions and/or items of income.

How does it work? Assume that a taxpayer would otherwise have taxable income of $500 in each year if it did not change its accounting method. If the tax rate changes from 35 percent in Year One to 20 percent in Year Two, the taxpayer will save $15 of tax by accelerating $100 of expense into Year One and reducing taxable income subject to the higher 35 percent rate.

In planning for a rate change, every dollar of federal deferred tax assets existing on a taxpayer's balance sheet (at the present 35 percent tax rate) may represent an opportunity to take advantage of a permanent economic and earnings benefit. Likewise, the potential to create or increase a deferred tax liability prior to the effective date of a tax rate decrease would provide an equivalent opportunity for a permanent earnings benefit.

If, however, a taxpayer takes no action in anticipation of a corporate rate reduction, and such reduction materializes, the company may have a reduction upon remeasurement of its deferred tax assets resulting in additional income tax expense on the income statement, assuming the deferred tax assets reflect a 35 percent rate. The adverse impact from remeasuring existing deferred tax assets would generally be based on the difference between the deferred tax assets valued at the 35 percent rate and the lower rate. Click here for a detailed example of the direct impact on financial statement earnings (negative with no planning and positive with planning). In contrast, deferred tax liabilities must be remeasured generally resulting in a deferred tax benefit. *The key is implementing an accounting method change or transaction in a year prior to when the tax rate reduction would become effective.*

Accounting method change opportunities specifically for E&C companies include:

- Change from using a long-term contract method of accounting that the company is not required to use. Service activities **(**e.g., engineering, architecture, construction management, commercial painting, computer software development, and performance under a guaranty,

warranty, or maintenance contract) are not long-term contract activities (unless they are related party services that benefit a long-term contract). An E&C company that is using the percentage of completion method ("PCM") under section 460 and that is not required to do so, may make an accounting method change off the PCM to an accrual method. Note this accounting method change must be filed within the year of change under the non-automatic change procedures.

- Change to the simplified cost-to-cost method of allocating costs to a long-term contract if the company is required to use the PCM. Under the simplified cost-to-cost method an E&C company determines a contract's completion factor based upon only (1) direct material costs; (2) direct labor costs; and (3) depreciation, amortization and cost recovery allowances on equipment and facilities directly used to manufacture or construct the subject matter of the contract. An E&C company makes the election to use the simplified cost allocation method by using the simplified method for all long-term contracts entered into during the tax year of the election on its original income tax return for the election year. This election is a method of accounting applies to all long-term contracts entered into during and after the tax year of the election.

Some common accounting method changes that are also applicable to E&C companies are:

Common Automatic Consent Method Changes	Common Non-Automatic Method Changes	Example Non-Accounting Methods Planning
• Inventory valuation • Reduction of section 263A UNICAP capitalization • LIFO inventory methods • Deferred revenue / advance payments • Prepaid expenses • Insurance • Certain service contracts • Accrued liabilities • Professional services • Payment liabilities • Rebates • Deferred compensation – related FICA/FUTA accruals • Fixed assets • Cost segregation of new and/or existing depreciable tangible personal property • Software development and intangibles	• Revenue recognition • Advance payments for the sale of goods • Long-term contracts • Pension and certain compensation expenses • Fixed assets (such as repair and depreciation where a tax credit was claimed)	• Change contract terms by prepaying expenses • Prepay bonus pools early in order to fix the liability.

Mitigating the Deemed Repatriation

The potential tax is determined by the amount of cash left offshore and the amount of E&P left offshore. Since the higher rate is to be applied to available cash, a reduction of the amount of available cash may minimize the potential future tax liability. Some simple ideas:

- Deploy it in the business,
- Pay down any offshore debt
- Repatriate cash
  - First from entities that have Previously Taxed Income, then
  - Any high-taxed earnings that can be fully credited.

Repatriating cash has the bonus impact of reducing the amount of E&P held offshore as well. If you can bring back E&P that can be fully offset by foreign tax credits, you should endeavor to bring it back now (assuming that the benefit is not offset by adverse currency positions) Other techniques to reduce E&P should be explored.

To reduce the impact further, you should look to optimize the E&P of the CFC. Accounting methods impact the determination of E&P that might be repatriated. So, optimizing accounting methods as discussed above to reduce the amount of E&P that might be deemed repatriated reduces the potential tax. As a cautionary note, it is possible that Congress would select a retroactive date for the measurement of E&P, which could thwart some of the planning in this area.

Adjusting to Border Adjustment

The most immediate task is to make sure that the effect of a destination-based tax system is considered in all contracts entered into that have components procured or produced outside of the United States. With narrow margins, the inability to deduct the costs that are incurred offshore can eliminate the profit and hide the effect in the taxes.

So, either the pricing will need to consider the added tax cost of the border adjustment or the contract will need to be split so that the customer carries the tax burden directly It may be advisable that contracts not be dollar denominated in order to allow potential currency gains to ameliorate the impact of border adjustability on imports.

In Conclusion

After you have assessed the impact of tax reform and optimized the benefits and mitigated the detriments that might come to pass, you should decide whether to get involved. Each separate component of the Blueprint has winners and losers and you must decide if the impact of any one provision is enough to take an active part in the legislative process.

Once tax reform is completed, you will need to adapt your business to the changes. That could involve modifications to your capital structure, procurement, possibly reconsidering the enterprises entire value chain. But, that is the desired result of this tax policy.

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