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Year-End Tax Planning for the Construction Industry

CFMA Central Ohio Chapter
November 19, 2013

Audit | Tax | Advisory | Risk | Performance

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Review of Recent Legislation and Tax Increases

Bonus Depreciation

- **<u>Bonus Depreciation</u>**

- 50% of the cost of “new use” assets acquired prior to Jan. 1, 2014
- Analyze pre-purchase benefit of 2014 capital acquisitions
  - Watch out for mid-quarter applicability
- Calendar year concept (fiscal year filers must determine assets acquired prior to or subsequent to 1-1-2014)

- **Key take away for contractors** – If the bonus provisions are not extended again past the current cutoff date of Jan. 1 , 2014, consider the tax planning effects of capital acquisitions prior to Dec. 31, 2013. Keep in mind the bonus deprecation provisions are based upon a calendar year end regardless of the taxpayer’s fiscal year-end. Additionally, note that contractors that lease property prior to buying it, will not be eligible to take bonus depreciation since the lessor is deemed the original owner of the property.

Section 179

- Set to revert to pre 2002 limitations for tax years beginning on or after Jan. 1, 2014
- Cannot create a net operating loss (limited by taxable income)
- Fiscal year concept
  - Watch for fiscal year pass-through limitations.
- As with bonus depreciation, analyze pre-purchase benefit of 2014 capital acquisitions

Section 179	2012 – Pre ATRA	2012 – ATRA	2013 - ATRA	2014 –ATRA
Expensing Limit	$139,000	$500,000	$500,000	$25,000
Investment Phase-out	$560,000	$2,000,000	$2,000,000	$200,000

- **Key take away for contractors** – As with bonus depreciation, the benefits of Section 179 allow taxpayers the ability to "plan" out taxable income based upon the timing of capital acquisitions.

*American Taxpayer Relief Act of 2012

Personal Income Tax Brackets

- For single individuals (other than heads of households or surviving spouses)

2012 Tax Table		2013 Tax Table	
If taxable income is:	The tax would be:	If taxable income is:	The tax would be:
Not over $8,700	10% of taxable income	Not over $8,925	10% of taxable income
Over $8,700 but not over $35,350	$870 plus 15% of the excess over $8,700	Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $35,350 but not over $85,650	$4,867.50 plus 25% of the excess over $35,350	Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $85,650 but not over $178,650	$17,442.50 plus 28% of the excess over $85,650	Over $87,850 but not over $183,250	$17,891.25 plus 28% of the excess over $87,850
Over $178,650 but not over $388,350	$43,482.50 plus 33% of the excess over $178,650	Over $183,250 but not over $398,350	$44,603.25 plus 33% of the excess over $183,250
Over $388,350	$112,683.50 plus 35% of the excess over $388,350	Over $398,350 but not over $400,000	$115,586.25 plus 35% of the excess over $398,350
		Over $400,000	$116,163.75 plus 39.6% of the excess over $400,000

- **Key take away for contractors –** Understand the increased tax bill due to the utilization of a pass through entity and how such structure affects the taxpayers long term planning goals. Companies in growth mode who must leave all profits in the company may desire to analyze C Corporation versus S Corporation status, since C Corporations are generally taxed at a maximum federal tax rate only 34%

Additional 0.9% Payroll Tax

- The 2010 Health Care Act assessed an additional hospital Insurance (HI) tax of 0.9% on certain wages and self-employment income (paid by the employee). The HI tax is assessed against wages and other self-employment income in excess of certain thresholds.

Filing Status	Wage/Self Employment income threshold
Married filing joint and surviving spouses	$250,000
Head of household	$200,000
Single	$200,000
Married filing separate	$125,000

- **Key take away for contractors –** Determine the timing of bonus payments based upon the specific tax situation of owners and other highly compensated employees. This tax only reinforces the utility of using an S Corporation structure, since the income passed out on the K-1 to "active" owners would neither be subject to the 3.8% Medicare Tax nor to the 0.9% payroll tax.

Qualified Dividends and Long Term Capital Gains

- The ATRA has made permanent the 15% tax rate on qualified dividends and long term capital gains, except for high income taxpayers. For taxpayers whose taxable income exceeds a specified threshold (see below) the top rate for capital gains and dividends will permanently raise to 20%, a 5% individual income tax increase.

Filing Status	Taxable income threshold
Married filing joint and surviving spouses	$450,000
Head of household	$425,000
Single	$400,000
Married filing separate	$225,000

- **Key take away for contractors –** For contractors with real estate holdings, consider planning for the timing of transactions based upon the anticipated long term capital gain rate to be applied to the transaction (in addition to the net investment income tax (NIIT)). Depending on the taxable income of the reporting taxpayer (pass-through entity owner) such transaction may be taxed at 15% (long-term capital gain rate of 15%) only for non-high income taxpayer or 23.8% (long term capital gain rate of 20% and NIIT rate of 3.8%) for high income taxpayers.

Additional 3.8% Medicare Tax (Net Investment Income Tax)

- Additional 3.8% Medicare tax calculated on Form 1040 on Net Investment Income (NIIT)
- Tax applies to gross income from:
  - Interest
  - Dividends
  - Annuities
  - Royalties
  - Rents
  - Passive activities (K-1s)
- The NIIT is on the lesser of (a) net investment income or (b) the excess of modified adjusted gross income (MAGI) over the applicable threshold amount.

Filing Status	Taxable income threshold
Married filing joint and surviving spouses	$250,000
Head of household	$200,000
Single	$200,000
Married filing separate	$125,000

Net Investment Income Tax Examples

- Example 1 – Taxpayer with MAGI of $170,000 including $20,000 of investment income. The NIIT is zero as the taxpayer's MAGI ($170,000) does not exceed the threshold of $200,000.

- Example 2 – Taxpayer with MAGI of $205,000 including $20,000 of investment income. The NIIT is $190. The lesser of (a) net investment income ($20,000) or (b) the excess of MAGI over the applicable threshold ($205,000 - $200,000 = $5,000). $5,000 x 3.8% = $190.

- Example 3 – Taxpayer with MAGI of $425,000 including $20,000 of investment income. The NIIT is $760. The lesser of (a) net investment income ($20,000) or (b) the excess of MAGI over the applicable threshold ($425,000 - $200,000 = $225,000). $20,000 x 3.8% = $760.

Net Investment Income Tax – Contractors

- At first glance, it would seem the NIIT would have little impact to contractors. This can be far from the truth. Presented are two common business scenarios in which this new tax can have a significant impact on contractors.

- Scenario 1 – Self-charged rent for a commercial building
  - As part of estate, risk, and other business purposes, many construction company's commercial buildings and land are owned by the majority owner/owners of the contractor in a separate legal entity. This real estate is leased by the construction company from the rental entity in what is called self-charged rent pursuant to a "triple net lease" (meaning the lessee pays all real estate taxes, building insurance and maintenance on the property).

- Scenario 2 – Self-charged rent for personal property (equipment rental)
  - Many contractors employ the use of an equipment rental entity structure for reasons similar to those of real property (building/land) rental entities.

- IRS guidance to date does not clarify a solution for these common "self-rental" activities.

Net Investment Income Tax

- To be excluded from the NIIT, an item of “trade or business” income must meet two tests:
  - First, the income must be from an activity that is not passive as defined under IRC 469. Self-charged rental income will generally meet this definition (rules for losses from self-charged rent are different), as long as the owner of the rental entity materially participates in the entity renting the property .
  - Second, the income must be from a trade or business as defined under IRC 162. Treasury Regulations state the active conduct of a trade or business does not include the ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property. In addition, IRS commentary since the release of the proposed regulations related to the NIIT generally confirm that a triple net lease will not be considered a trade or business. ***The regulations which are to be utilized in applying the NIIT are currently in proposed form and the final regulation may vary from the proposed regulations.***

Summary Example of 2013 Tax Increases

- Taxpayer is an S Corporation (wholly owned by an individual) with $1,000,000 taxable income before owner bonuses. As part of the taxpayer's tax and business planning of stripping as much income as bonding and banking allows, the S Corporation pays a bonus to the shareholder of $250,000 in addition to the shareholders annual salary of $275,000. In addition to the K-1 and wages from the S Corporation, the shareholder has long term capital gains and qualified dividends of $300,000 (resulting mainly from a real estate transaction).

- The cash flow summary of the activity is as follows (highest effective rates have been used for presentation purposes).

Summary Example of 2013 Tax Increases – Continued

		2012 Tax Summary		2013 Tax Summary
K-1: $750,000 (after bonus)	Effective 35% Rate	$262,500	Effective 39.6% Rate	$297,000
W-2 $525,000 (including bonus)	Effective 35% Rate	183,750	Effective 39.6% Rate	$207,900
			Additional 0.9% HI Tax (excess over $250,000)	$2,475
Long-Term Capital Gains and Qualified Dividends $300,000	15% Rate	45,000	Effective 20% Rate (taxable income exceeds threshold of $450,000)	$60,000
			Additional 3.8% Medicare tax	11,400
Tax Summary				
Total Income		$1,575,000		$1,575,000
Total Taxes		$491,250		$578,775
Effective Rate		31.19%		36.75%

Have these changes changed your entity of choice?

- Depends on long term strategy
- C Corp retain more current cash flow
- Pass-through provides basis for future disposal
- Partnership subjects partners to additional 0.9% tax on self-employment income

	C Corp	Active 1120-S	Active 1065
10 Year Income Projection	$ 8,000,000	$ 8,000,000	$ 8,000,000
Effective Rate	34.00%	39.60%	39.60%
Self Employment Taxes			3.80%
Tax on Corporate Earnings	2,720,000	3,168,000	3,472,000
Equity Left in Company	5,280,000	4,832,000	4,528,000
Third Party Exit Strategy			
Sales Price (NBV)	5,280,000	4,832,000	4,528,000
Basis	0	4,832,000	4,528,000
Gain on Sale	5,280,000	-	-
Capital Gain Rate	20.00%	20.00%	20.00%
NIIT - Medicare Sur Tax	3.80%	3.80%	3.80%
Tax on Sale/Liquidation	1,256,640	-	-
Net Cash Remaining	$ 4,023,360	$ 4,832,000	$ 4,528,000
State tax issues and other consideration will change these results			

Final §263(a) and §162(a) Regulations and Re-proposed §168(i) Regulations

Overview

Final and re-proposed regulations cover four main subject matter areas:

Material and Supplies	Acquisition of Tangible Property	Improvements to Tangible Property	Dispositions of Tangible Property
▪ Deal with the timing of deducting costs for incidental and non-incidental supplies ▪ Expand the definition of a material and supply to cover items that cost less than $200 ▪ Allow taxpayers elective capitalization of certain material and supplies ▪ Provide a general rule for timing of deducting cost of rotable, temporary, and standby emergency spare parts ▪ Establish an optional method for rotable and temporary spare parts	▪ Provide determination of what costs need to be capitalized for the acquisition or production of tangible property ▪ Provide for treatment of facilitative and inherently facilitative costs ▪ Establishes a “whether and which” test for the acquisition of real property ▪ Allows the expensing of employee compensation and overhead ▪ Provide de minimis rule with per item/invoice threshold	▪ Define unit of property for applying the betterment and restoration standards related to real and personal property ▪ Create a safe harbor for routine maintenance ▪ Provide guidance regarding what constitutes a betterment or restoration of property ▪ As part of the restoration rules, illustrate what is considered a major or substantial component ▪ Provide guidance to determine when the property has been adapted for a new or different use	▪ Provide framework for dispositions of partial assets ▪ Revise the General Asset Account rules ▪ Provide guidance regarding determining net basis in a partial disposition

Materials and Supplies Defined § 1.162-3(a)(2)(c)

Tangible property that is used or consumed in the taxpayer's operations

- Not inventory
- Component acquired to maintain, repair, or improve a unit of property
- Fuel, lubricants, water, and similar items that are reasonably expected to be consumed within 12 months or less
- UOP that has an economic useful life of 12 months or less beginning when the item is used or consumed
- UOP with acquisition cost $\leq$ \$200
- Identified in published guidance issued by the Internal Revenue Service (IRS)

Rotables, Temporary, and Emergency Spare Parts Methods

- General rule § 1.162-3(a)(3)
  - Deducted in year the part is disposed
- Capitalize and depreciate § 1.162-3(d)
  - Election made on timely filed original return
  - Election made by capitalizing and placing asset in service – depreciation begins
  - Election is revoked through PLR request
- Optional method § 1.162-3(e)
  - Does <u>NOT</u> apply to emergency standby parts
  - Must apply to the same pools of parts for book and tax, <u>OR</u>
  - If not used for book, then tax must use for all pools in trade or business
    - Initial installation – Deduct amount paid
    - Removal – Include FMV in income <u>AND</u> include FMV in basis + removal costs
    - Repair – Add costs to basis
    - Re-installation – Deduct re-installation costs and basis

De Minimis Safe Harbor Election

De Minimis Safe Harbor
Elected

- Removed ceiling of “up to .1% of gross receipts or 2% of depreciation expense”
- Safe harbor is elective, not mandatory
- Applicable financial statements = $5,000 per item
- No applicable financial statements = $500 per item
- Changes to book accounting policies is not a method change

De Minimis Safe Harbor
Not Elected

- Taxpayer bears burden of proof to show method clearly reflects income

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Acquisition of Tangible Property

Costs to Acquire Property Defined § 1.263(a)-1(f)

Transaction Costs

- A taxpayer must capitalize costs incurred in the process of investigating or otherwise pursuing a transaction to acquire tangible real and personal property.
- The determination of whether costs are facilitative is based on all the facts and circumstances surrounding the transaction.

Inherently Facilitative Costs

- Transporting property
- Securing an appraisal
- Negotiating the terms of an agreement
- Application fees
- Preparing and reviewing documents for property acquisitions
- Examining and evaluating title to the property
- Obtaining regulatory approval
- Conveying property between parties (sales and transfer taxes)
- Finders fees
- Architectural, geological, engineering, environmental, or inspection services
- Qualified intermediary or other services (Sec 1031)

§1.263(a)-3 Amounts Paid to Improve Tangible Property

Unit of property for betterment and restoration analysis:

Real Property	Personal Property	Condominiums and Cooperative	Network Assets

▪ Building structure
▪ Building systems:
  ▪ HVAC
  ▪ Plumbing system
  ▪ Electrical system
  ▪ All escalators
  ▪ All elevators
  ▪ Fire protection
  ▪ Security system
  ▪ Gas distribution
  ▪ Other systems based on IRS guidance
	▪ General property:
	  ▪ Functional interdependence
	  ▪ Facts and circumstances
	▪ Plant property:
	  ▪ Functional interdependence
	  ▪ Discrete and major function
		▪ Generally the portion of the building owned and its structural components
		▪ Building structure owned
		▪ Building systems
			▪ Facts and circumstances
			▪ Published guidance

Improvements to Tangible Property

§1.263(a)-3 Amounts Paid to Improve Tangible Property

Improvements to property analysis:

Betterment	Restoration	Adaptation
▪ Corrects a material condition or defect at acquisition or production ▪ Material addition – physical enlargement, expansion, or addition of a major component ▪ Material increase in productivity, efficiency, strength, quality, or output.	▪ Replacement and recognition of a loss on disposal of a component ▪ Recognition of gain/loss on sale of component ▪ Basis adjustment as a result of a casualty loss ▪ Return to former operating condition when no longer functioning ▪ Rebuild like new condition after class life ▪ Replacement of major component or substantial structural part	▪ Adapts the property to a use not consistent with the intended ordinary use when originally placed in service

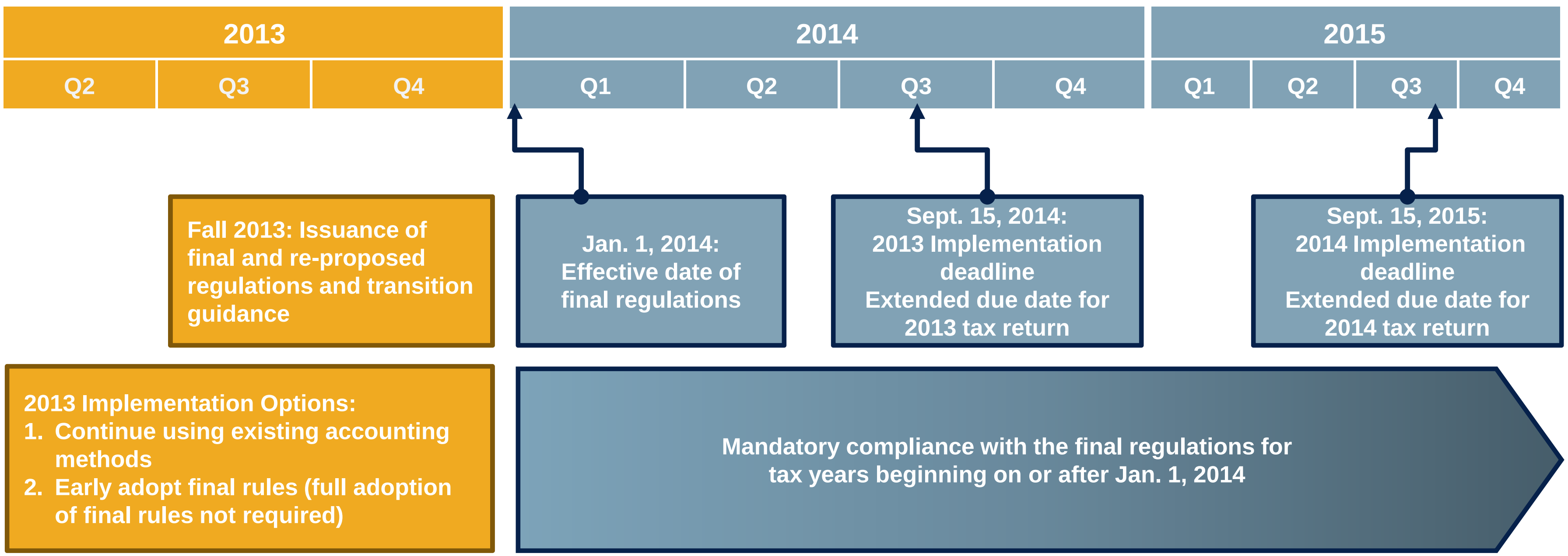
Dispositions of Tangible Property

- Temporary regulations used complicated rules to take partial dispositions through general asset accounts
- The proposed regulations under § 1.168(i)-8 include the election to dispose of structural components in a building and components of tangible personal property.
- A disposition includes:
  - Sale or exchange
  - Retirement
  - Physical abandonment
  - Destruction
  - Transfer to a supplies, scrap, or similar account
  - Retirement of a structural component of a building
  - Involuntary conversion
- Application of the rule applies to both tangible personal property and real property and is determined in the year of disposition.

Implementation Timeline

Next Steps 2013

- Begin to assess and quantify the potential impact of the regulations
- Understand which methods and elections need to be adopted/made based on specific facts and circumstances
- Consider impact of current book policies
- Assess the benefits of early adopting the final regulations



Construction-Specific Year-End Tax Planning Strategies and Considerations

Domestic Production Deduction – IRC 199

- Deduction equal to 9% of Qualified Production Activities Deduction (QPAI)

- Variety of construction activities qualify
  - Residential and commercial construction
  - Infrastructure
    - Water
    - Road
    - Power
    - Communication
  - Determine maintenance versus construction contracts
    - Erect or substantially renovate real property
    - Gibson & Assoc. Inc. v. Commissioner of Internal Revenue

Expiring Tax Provisions – Section 179D

- Section 179D – Maximum permanent deduction of $1.80 per square foot of qualifying property
- Notice 2008-40
  - Government entity "may allocate" deduction to designer
  - Who is designer?
    - "Person who creates the technical specifications for installation of" qualifying property
    - designer may include, for example, an architect, engineer, contractor, environmental consultant, or energy services provider who creates the specifications
    - A person that merely installs, repairs, or maintains the property is not a designer
    - If more than one designer – building owner gets to decide, either allocate 100% to primary designer or allocate among the designers
- Post office
- Universities
- Military facilities
- Other government owned property

Expiring Tax Provisions – Research and Development Credit

- Set to expire effective Dec. 31, 2013

- The Section 174 Test (the Uncertainty Test)
- The Discovering Technological Information Test
- The Business Component Test (The Permitted Purpose Test)
- The Process of Experimentation Test

Expiring Tax Provisions – Research and Development Credit

- Examples of Qualifying Activities
  - Experimentation with new material combinations and evaluation of their performance properties
  - Development of innovative assembly or construction methods that accelerate or improve the construction process associated with large infrastructure assets
  - Unique bridge or roadway designs
  - Unique construction or innovation techniques in untested invironments
  - Building designs to support unique structures
  - Design and development of unique energy-efficient buildings and/or features
- Examples of Nonqualifying Activities
  - Participating in meetings with the city or county to obtain zoning review of plans
  - Producing drawings or promotional materials
  - Participating in marketing efforts
  - Assisting in the review or development of bid packages related to building or component construction
  - Participating in building construction scheduling or construction oversight services to verify that the building and its components are constructed according to the design specifications

Long-Term Planning Considerations

- Succession planning
- Employee stock ownership plans (ESOP)
- Captive insurance company
- Year-end changes
- Dealer procurement structure
- Asset protection – holding company, etc.
- Self-employment tax planning for LLCs