

Pyramid

Fourth Quarter 2008

Practical ideas for construction and real estate organizations

Strategies to improve your tax position in the coming year

In the ever-changing world of tax law, it's wise to remain focused on some of the basic (also known as "blocking and tackling") deductions, methods, deferrals and credits that every construction company should take advantage of — or at least discuss with a trusted tax advisor.

For some, this is a friendly reminder. For those new to the construction industry or the financial management role, you might find the following information — written for entity-level tax planning ideas — useful. Keep in mind, the goal is reducing taxes while, in turn, increasing your company's cash flow and enhancing shareholder/partner value.

Accounting methods

Accounting methods deal with issues such as the recognition of income and expenses, capitalization of certain expenses and treatment of prepaid expenses. By modifying your company's accounting methods, you might find opportunities for significant tax deferrals and current-year tax reductions. Deferring income to the next tax year often makes sense from a tax perspective. Sometimes, it's the best you can do because the IRS doesn't allow countless exclusion of income items. The opportunities available to your construction company will depend on whether or not you use the completed contract or percentage of completion, or the cash or accrual method.

Being in the construction industry, it's nice to know you only have two methods of accounting to worry about. A contractor has a method of accounting for its construction contracts and a method of accounting for its non-contract income and expenses.

Obviously, when deciding to implement any of these options, you should obtain a complete understanding of the facts regarding your current arrangements, contracts and accounting methods. It will help determine the tax and business ramifications. Some method

changes are automatic while others require prior IRS approval. Accounting methods to consider include:

- **Defer income and accelerate deductions:** In potentially high-income years, consider deferring some income to later years or accelerating deductions in the current year. For example, if your business uses the cash method of accounting, you could delay billing invoices as you approach year-end and pay as many expenses as possible. If you want to accelerate deductions and don't have ready cash, think about charging expenses on your bank charge card.

If you use the accrual basis, make sure to capture all of your current payables into expense. For instance, if you accrue the last week of payroll, are you also accruing for those related payroll expenses? Bonuses, vacation pay and charitable contributions may be deducted in the current year if paid within the first two-and-a-half months of the following tax year. Remember, you can't accrue and deduct expenses related shareholders or partners for tax purposes. These related party accruals must be paid before the end of the tax year on the cash basis to garner the deduction. Therefore, if your company has related party accruals, review the company's cash position at year-end to determine if it makes sense to pay these accruals before the end of the tax period. (The shareholder or partner may not like the income in the current year so you should talk it over with them.)

If your company contributes to a profit-sharing plan, be sure to accrue the company's contribution. The company will have until the extended due date of their tax return (a possible eight-and-a-half months after year-end for a calendar year corporation) to make a deductible contribution for the previous tax year.

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What does the Economic Stimulus Act of 2008 mean for your property?

In February 2008, The Economic Stimulus Act of 2008 was signed into law. Its aim was to help stall a recession and encourage new business investment. Under this act, the accelerated depreciation provisions of IRC §168 have been amended, allowing increased first year depreciation deductions for qualifying property placed into service during 2008, as well as additional §179 deductions.

An additional first-year depreciation deduction equal to 50 percent of the depreciable basis of the property is allowed for both regular and alternative minimum tax purposes. This deduction is generally determined without any proration for the amount of time during the year which the property is in service. To be eligible, the property must be qualified property placed into service during 2008. The depreciable basis of the property must be adjusted by the amount that is claimed as a bonus depreciation deduction.

Bonus depreciation isn't available for assets required to be depreciated under §168(g), the Alternative Depreciation System or qualified New York Liberty Zone Leasehold Improvement Property. There is a special provision for certain long-lived assets, which if placed in service prior to Dec. 31, 2009, will still qualify.

To be considered qualified property, it must meet certain requirements. The property must be property to which general Modified Accelerated Cost Recovery System rules apply, with a recovery period of 20 years or less. Most tangible personal property will meet this test; however, most real estate assets will fail to meet this definition and thus will not be eligible for the additional deduction. The original use of the property must have begun with the taxpayer after Dec. 31, 2007. The taxpayer must have acquired the property after Dec. 31, 2007 but before Jan. 1, 2009. The asset must be acquired by the taxpayer prior to Dec. 31, 2007, and placed into service in the same year. Finally, if a binding contract to acquire this property existed before Jan. 1, 2008, the property will not qualify for the bonus depreciation provisions.

The additional first-year bonus depreciation deduction is also available for the cost of qualified leasehold improvement property if it meets all of the following tests:

- The improvement must be made to the interior portion of the building and the building must be non-residential real property.
- The improvement must be made pursuant to or under a lease either by the lessee or sub-lessee or the lessor to property that will be occupied exclusively by the lessee or sub-lessee.

- The improvement must be placed in service more than three years after the date the building was first placed in service.

Similar to prior years, a taxpayer may elect out of taking bonus depreciation. In order to elect out of these provisions, the election must be made by the due date — including extensions — of the tax return for the year the property was placed in service.

The provisions of §179 were also amended under the Economic Stimulus Act of 2008. The §179 election allows taxpayers who are in a trade or business to expense tangible personal property immediately, rather than depreciate it over its useful life, thus accelerating the deduction to the current year. This new provision allows for a §179 deduction of \$250,000 during 2008. This is a 95 percent increase from the previous limitation of \$128,000. The Economic Stimulus Act also increases the §179 phase out limitation for property placed in service, from \$510,000 previously, to an increased 2008 limit of \$800,000. The expense amount is reduced dollar for dollar once the threshold is reached. Therefore, any taxpayer placing into service more than \$1,050,000 worth of property during 2008 would have their section §179 expense reduced to zero. The §179 expense can't create or add to a taxable loss, so there will be no current year benefit unless there is sufficient taxable income. A business that can't use the full amount of their §179 deduction in the current year may carry the expense forward to offset taxable income in the following years. A qualified asset may be eligible for both the §179 deduction and the bonus depreciation provisions.

The Economic Stimulus Act also allows additional 2008 depreciation for passenger automobiles, as well as for trucks and vans used in a business. For vehicles that the 50 percent bonus depreciation doesn't apply, the 2008 depreciation limits are \$2,960 for cars, and \$3,160 for trucks — those limits are increased to \$10,960 and \$11,160, respectively. These limits are reduced if the business use of the vehicle is less than 100 percent. In addition to these increased limits, the automobile lease inclusion tables have also been updated.

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- **Percentage of completion exceptions:**

These rules allow contractors two exceptions from using percentage of completion when calculating their income for tax purposes:

Any home construction contract; or, for contractors with gross receipts less than \$10 million, any other construction contract that will be completed within two years. For large contractors with gross receipts greater than \$10 million, the completed contract can still be used for home construction contracts.

Why do you want to use completed contract?

Once again, deferral of income. Completed contract provides tax payers with a longer deferral of income recognition for construction contracts than percentage of completion. Bear in mind, once the job is 95 percent complete, the IRS views it as being completed and all income must be recognized. So, reviewing your contract schedule early and planning ahead could defer that income recognition one more year.

- **Ten percent deferral method:** One tax savings potential available for large construction companies is the 10 percent deferral method. It allows a taxpayer to defer the income from all contracts that are less than 10 percent complete. This income is deferred until the contract is greater than 10 percent complete. It's a one-time election available to any construction company using the percentage of completion method.
- **Twelve-month rule:** Instead of parking expenses on the balance sheet, deduct them when you pay them. The IRS has recently relaxed the capitalization rules to all taxpayers to take deductions for items, including insurance contracts and the following prepaid contracts: warranty, maintenance, software maintenance, yellow pages advertising and business licenses – among others. The full deduction is allowed in the year of payment and must be for a contract/agreement with a life of 12 months or less.

- **Like-kind exchanges:** Equipment is the lifeblood of many construction companies and one of the most significant assets on their balance sheet. Many contractors recognize significant taxable gains from the disposal of their equipment; but others, in an attempt to avoid such gains, trade in equipment. Even though this decision defers gain, it may or may not make sense economically. The like-kind exchange rules may be used to prevent an unwanted taxable gain and allow the contractor the freedom to decide whether an outright sale or trade-in makes sense for the disposal of equipment. Most companies are aware of the trade-in method, but the deferred like-kind exchange provides companies with the same benefits of the trade-in method while allowing companies to sell their property outright for more money. The use of a qualified intermediary is required to hold the sales proceeds and to use the proceeds to acquire the replacement property within 180 days.

- **Take advantage of the domestic manufacturers' deduction because it's only going up:**

Even though the title doesn't allude to it, the deduction is available to businesses engaged in construction, engineering and architectural services. Also known as the Section 199 deduction, this provides businesses with a variety of planning and computational challenges and opportunities.

The deduction is limited to your qualifying production activity net income which for a construction company is defined as new construction or substantial renovation conducted in the U.S. The deduction is also limited to the lesser of qualifying production activity net income or current year taxable income. In 2008 and 2009, the domestic manufacturing deduction is 6 percent with the deduction increasing to 9 percent in 2010 and thereafter.

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