Mueller Prost
CPAs + Business Advisors

DIMENSIONS

A CPA's Report to the Construction Industry

NEW REPAIR AND MAINTENANCE EXPENSE REGULATIONS

Clear Answers Are Still Not Easy to Find

Last September, the Internal Revenue Service issued long awaited final regulations governing how expenditures for the repair and maintenance of buildings, equipment and other tangible assets should be treated for tax purposes. In many instances, these new regulations (IRS T.D. 9636) will require you to change the way you treat such expenditures on your tax returns. What's more, most contractors will encounter significant new record-keeping requirements.

How We Got Here

Like most taxpayers, contractors generally prefer to deduct repair and maintenance expenses from their income in the year that these expenses are incurred in order to reduce their current tax liability. But, if such expenditures increase the value of the asset or extend its useful life, they should be capitalized and then depreciated over a period of years.

Consider, for example, the cost of overhauling a worn out engine in an expensive earthmover, or replacing a failed air conditioning compressor in a commercial building. Both of these could be classified as necessary maintenance, but one could also argue that the repairs increase the value of the asset and therefore should be capitalized and depreciated.

The new regulations are the result of nine years of effort by the IRS to clarify when such costs can be expensed and when they should be capitalized. The final regulations, which must be followed by all taxpayers for the tax year that began January 1, 2014, impose many additional administrative requirements that will affect almost every contractor.

Maintenance or Improvement?

Routine maintenance costs are deductible under the regulations, but the costs of improving a tangible asset are not. Routine maintenance is defined as a recurring activity that's necessary to keep the unit of property in "ordinarily efficient operating condition."

Improvement, on the other hand, is defined as an activity that results in:

- **A betterment of the property:** Correcting a pre-existing defect or causing a material increase in capacity, productivity, efficiency, strength, quality or output.
- **Restoration of the property:** Returning a unit of property to ordinarily efficient operating condition after it had deteriorated and was no longer functional.
- **Adaptation of the property:** Making it possible to use the asset for a new or different purpose.

Generally speaking, maintenance refers to activities that you can expect to perform more than once during the usable life of the asset. In the case of a building, maintenance activities are those you can reasonably expect to perform more than once over a 10 year period at the time the building is placed in service. Note, however, that this is only one guideline; there are numerous other factors to consider.

In our earlier engine and compressor examples, both repairs restored assets that had deteriorated. So the costs would need to be capitalized and then depreciated.

For buildings, the regulations require you to apply the repair standards separately to the overall structure and to nine specific building systems — HVAC, plumbing, electrical, escalators, elevators, fire protection, security, gas distribution and other systems to be defined in published guidance. In addition to adding to your record-keeping requirements, this also makes it more likely that most repairs will require capitalization.

Clear Answers Are Still Not Easy to Find, cont.

Safe Harbors and Exceptions

The new regulations include an annual "safe harbor" election for taxpayers with average annual gross receipts of $10 million or less. Such contractors may elect not to capitalize improvements to a building that has an unadjusted cost basis of $1 million or less as long as the total amount they paid during the tax year for repairs, maintenance and improvements does not exceed $10,000 or 2 percent of the unadjusted basis, whichever is less.

The regulations also provide "de minimis" expensing rules for certain taxpayers, allowing them to expense up to $500 per item if they had a written expensing policy in place at the beginning of the tax year. There is a de minimis safe harbor of $5,000 for taxpayers who prepare "applicable financial statements" (such as audited financial statements or certain other government-required statements).

The goal of these regulations was to make expensing decisions less subjective and open to interpretation. In many cases, however, deciding whether a repair cost should be expensed or capitalized will still be something of a judgment call. In almost every instance, the administrative and documentation requirements have increased considerably.

Please call Mueller Prost today to learn more about these new regulations and what you should do now to comply. 314.862.2070

GETTING PAID FOR YOUR WORK

Practical Ways to Prevent Problems

When a project runs into financing problems, this is more than merely disruptive. It can threaten the success of the project and the very survival of the contractor.

Avoiding such unwelcome problems requires thorough prequalification of the project owner, adequate protections in the contract language, and clear and open communication throughout the project.

Owner Prequalification: A Critical Step

It might seem safe to assume that a project owner would not start construction until financing was in place, but that assumption can expose a contractor to significant risk. Before expending substantial time and resources preparing bid packages and estimates, a wise contractor will take some preliminary steps to be sure financing is reasonably secured.

This involves some balancing of risks — primarily, the risk of alienating a project owner early in the relationship versus launching a project that causes cash flow problems later. If handled tactfully and openly, however, the project will start out on solid footing.

It's natural to feel more confident when working for an owner with whom you have a longstanding history, but a wise contractor will perform due diligence on every project. Circumstances can change quickly, and the owner who was rock solid a year or two ago might be facing a very different financial situation today.

Government contracts are no exception to this rule. Diminishing tax receipts, growing pension obligations and other economic pressures are threatening the financial stability of a number of cities, counties and governmental agencies. Some jurisdictions are known for subjecting contractors to six to eight month delays in payment. If such payment lags are likely, this should be factored into the initial bid.

Public-private partnerships also require careful scrutiny. Such projects, in which buildings or infrastructure are financed by private investors and then leased back to government agencies, entail

Practical Ways to Prevent Problems, cont.

complex financing arrangements that often require special expertise to evaluate.

What and Where to Check

A prudent contractor will establish a thorough, step-by-step process for confirming financing at the outset of every project and then follow that process consistently. Begin by requesting full disclosure of project owners or major shareholders, along with routine banking, legal and accounting references. Above all, request a complete disclosure of all financing sources, including contact information and the level of commitment each source has offered.

In addition to running routine credit checks, it's good practice to search legal records for any history of litigation in all cities where the principals have operated. In particular, check to see if liens have been placed on past jobs.

And don't overlook the importance of reputation "on the street." Talk to other contractors and subcontractors who have experience with the customer, and take advantage of networking opportunities through local professional or trade organizations.

Contract Protections

Once a bid is won, make sure the final contract language includes provisions that allow you to ensure adequacy of funding and monitor financing developments during the course of the project. Owners may be reluctant to provide a lot of transparency in this area, but it is not unreasonable to expect some visibility into the flow of funds, and to build in contractual projections to ensure that payment is smooth and predictable.

Be sure that retention or hold-back provisions are clearly spelled out. In some instances, it's possible to work out modifications to the original retention terms, such as a partial release of retainage as the job nears completion. The contract should also spell out the specific conditions under which work may be suspended for nonpayment.

Clear and Consistent Communication

Regardless of the contract terms, it's good practice to convene a pre-construction meeting with the owner and financing source before significant work begins. Use this meeting to clear up any possible ambiguity about how payment will be made, what documentation the owner and financing source will require, and the specific requisition forms or processes to follow. If you haven't done so already, explain that your company monitors lien deadlines closely, and has a strict policy for filing liens automatically whenever a deadline approaches.

Clear communication remains a priority even after work gets underway. Prompt, accurate billing is one part of this communication process, as is careful management of change orders.

By monitoring project developments closely and maintaining consistent and open communication among all parties, you can greatly reduce the risk of unexpected financing problems or payment delays.

Please call your Mueller Prost advisor at 314.862.2070 if you would like to discuss other tools for maintaining positive project cash flow.

IRS Finalizes Net Investment Income Tax Regulations

On December 2, 2013, the Internal Revenue Service issued final regulations for implementing the 3.8 percent surtax on investment income, which was authorized under the Patient Protection and Affordable Care Act. The additional tax on high-income taxpayers, which the IRS calls the Net Investment Income Tax, was designed to cover rising Medicare costs resulting from the law.

The new regulations provide some relief to taxpayers who otherwise might have faced an additional tax obligation as the result of selling an interest in an S corporation or other pass-through entity. This is a tax structure used by many contractors.

The regulations also provide relief for taxpayers who rent property to businesses in which they materially participate, such as a contracting business that leases its building from a separate entity owned by the same owners. Under the final regulations, the rental income the property owner receives in this situation will generally not be subject to the 3.8 percent surtax, provided the owner materially participates in the operation of the contracting business. The regulations also provide a safe harbor for rental income earned by real estate professionals, along with a fairly narrow definition of who qualifies as a real estate professional.

Most of the general provisions remain unchanged from the earlier, preliminary regulations. For example, the surtax still applies to individuals whose modified adjusted gross income (MAGI) exceeds specific thresholds — $250,000 for married couples filing jointly, $200,000 for single taxpayers, or $125,000 for married couples filing separately.

MAGI is adjusted gross income minus certain deductions, such as IRA contributions, Roth IRA conversions or rollovers, student loan interest, tuition and fees. In other words, it's the last number at the bottom of page 1 of Form 1040.

The surtax is computed on the lesser of two figures:

1. Net investment income for the tax year, or

2. The amount by which MAGI exceeds the threshold for a taxpayer's filing status.

Net investment income is defined as interest, dividends, royalties, rents, capital gains and other passive income. There are a number of specific exclusions, though, including self-employment income, income from an active business, IRA distributions, or income from tax-exempt municipal bonds. The regulations also exclude gain from the sale of a principal residence, unless that gain is greater than $250,000 for single taxpayers or $500,000 for joint filers.

Because the surtax is imposed on net investment income or the amount by which MAGI exceeds the threshold (whichever is less), it is possible to reduce the surtax by rebalancing a portfolio to reduce either MAGI or net investment income. Popular strategies for doing this include Roth IRA conversions, shifting funds into tax-exempt or tax-deferred investments, adjusting the timing of the sale of assets and using installment sales to spread investment income over a period of years.

The final regulations are effective for tax years beginning after 2013, but the IRS indicated that taxpayers may rely on them for their 2013 returns as well.

Call us today at 314.862.2070 to explore strategies for reducing your Net Investment Income Tax obligation.

GAAP Alternatives Under Consideration

As U.S. generally accepted accounting principles (GAAP) have become more and more complex in recent years, many privately held businesses — including contractors — are finding GAAP compliance to be a significant burden. Fortunately, the Financial Accounting Foundation (FAF) and the American Institute of Certified Public Accountants (AICPA) have recently taken steps to respond to this problem.

In 2012, the FAF established the Private Company Council (PCC) to serve as the primary advisory body on the appropriate treatment for private — as opposed to publicly traded — companies. The goal of the PCC is to identify opportunities to reduce the complexity and costs of preparing private company financial statements that comply with Financial Accounting Standards Board (FASB) requirements.

The first two recommendations from the PCC covered accounting for goodwill and certain interest rate swap agreements. Both were endorsed by FASB last November.

Meanwhile, the AICPA has pursued a separate initiative, and last summer issued its new Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs). This framework is intended to serve as an alternative to financial reporting under U.S. GAAP by providing small to medium-sized businesses with a financial reporting model that is simpler, more concise and more cost effective, while still providing relevant financial information that statement users need.

FRF for SMEs provides an alternative accounting basis for small and medium-sized businesses to consider. However, since the AICPA has no authority to require users to accept it, its adoption requires the consent of third-party users. For the time being, most users of a contractor's financial statements — particularly bankers and sureties — still require financial statements that conform with U.S. GAAP.

If you have questions about GAAP requirements or other financial reporting frameworks, please call your Mueller Prost advisor at 314.862.2070.

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