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Contractors Can Benefit from Section 179D Deduction

Improving a building's energy efficiency can offer a significant long-term return but, in many cases, it can also generate more immediate financial benefits. For example, Internal Revenue Code (IRC) Section 179D offers a tax deduction to building owners who install energy-saving systems in new construction or who retrofit existing buildings.

In some cases, this deduction can be passed on to building professionals, yet the Section 179D deduction remains surprisingly underutilized among contractors.

Section 179D at a Glance

Section 179D provides a tax deduction of up to $1.80 per square foot for installing qualifying systems that improve a building's energy efficiency in three areas:

1. Lighting and lighting controls

2. Heating, ventilation and air conditioning (HVAC), including water and hot water systems

3. The building envelope, including roof, windows and doors

Inspection and testing must be completed by a qualified engineer or contractor registered in the building's jurisdiction.

The amount of the deduction cannot exceed the actual cost of the improvements, and the deduction reduces the remaining depreciable basis of the building. But instead of depreciating these expenses over a period of up to 39 years, the building owner can take the full deduction in the year in which the improvements are placed into service.

The Size of the Opportunity

The full amount of the deduction is available only on buildings that achieve at least a 50 percent reduction in total energy and power costs, as compared to the minimum requirements outlined in the American Society of Heating, Refrigerating and Air Conditioning Engineers (ASHRAE) Standard 90.1-2001. The savings are calculated separately for lighting, HVAC and building envelope systems. So, you may qualify for a partial deduction based on energy-efficient lighting, even if other building systems do not achieve enough savings to qualify.

The potential deduction can be significant. For example, on a 120,000-square-foot commercial building, the owner could be eligible for a Section 179D deduction of up to $216,000, provided energy usage is reduced by at least 50 percent over ASHRAE 90.1-2001 standards in the following three categories:

Maximum deductions, 120,000 sq. ft. commercial building

Lighting: $0.60/sf	$72,000
HVAC: $0.60/sf	$72,000
Building Envelope: $0.60/sf	$72,000
Total Potential Section 179D deduction	**$216,000**

Identifying Likely Opportunities

Although the Section 179D deduction is available for all types of commercial property, qualifying for the full $1.80 deduction requires detailed energy usage modeling using Department of Energy-approved software, so claiming the full deduction is usually most cost-effective on large buildings.

The partial deduction, on the other hand, enables building owners to target their efforts in those areas most likely to produce significant energy savings that qualify for a tax deduction. For example, a partial deduction of 30 cents to 60 cents per square foot is allowed for achieving a 25 percent to 40 percent reduction in lighting power density. This requires a

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less-intensive estimating effort and often offers a highly cost-effective retrofit opportunity.

A Direct Benefit Many Contractors Overlook

Contractors themselves may qualify for the Section 179D deduction. When energy-saving improvements are made to public buildings or commercial buildings owned by governmental entities, the deduction may be allocated to the taxpayer primarily responsible for designing the energy-saving improvements or allocated among multiple designers.

Many contractors, engineers, architects, environmental consultants and energy service providers have qualified for tax deductions in the tens of thousands of dollars using this provision – but many others remain unaware of this important benefit.

Even without this direct incentive, Section 179D offers contractors the opportunity to create a competitive edge. Educating project owners about a potentially advantageous tax provision is a good way to distinguish your company.

Moreover, the additional cash flow created by these deductions can make proposed projects or change orders more affordable. Section 179D could be the push that's needed to get a stalled project back on the front burner.

This incentive is scheduled to expire at the end of 2013, so now is the time to point out these opportunities to owners - and to investigate the potential of benefiting directly from this provision.

Call us today at 314.862.2070 to review tax incentives that may be available for your business.

New Accounting Standards Affect Many Contractors

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are currently working on more than a dozen projects aimed at aligning U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS).

While this might seem at first glance to be a highly technical development of interest only to accountants and financial executives, the impact of these new standards will extend far beyond accounting. Two standards, in particular, are expected to have serious financial and operational effects on many contractors.

Lease Accounting

Major changes are being proposed in the way lease contracts of longer than 12 months' duration are recorded. This includes not only leases of office and shop space, but also long-term leases of equipment and machinery.

Under the new standard, lessees would be required to record the present value of scheduled long-term lease payments as a liability, and record the right to use the leased property or equipment as an asset in the same amount. While these two figures offset each other on the balance sheet, the addition of debt will adversely affect several commonly used metrics of financial health, especially the debt-to-equity ratio.

This could cause many contractors to suddenly be out of compliance with loan covenants or surety requirements. It also will have the effect of "front loading" expense recognition since the liability will be amortized using the interest method, possibly causing an initial reduction in net income. In addition, the burden of complying with these reporting requirements would be significant, especially for contractors with limited in-house accounting resources.

Revenue Recognition

Like the lease accounting changes, proposed changes in GAAP revenue recognition standards would also impose a significant compliance burden on contractors, as well as seriously affect their financial statements. The most sweeping effect is the elimination of the percentage-of-completion method, which has long been the most widely used method in the construction industry for recording revenue from long-term contracts.

Under the proposed new standard, contractors would be required to break down long-term contracts into a series of separate "performance obligations," each of which would require allocations of the contract price, costs incurred to date and total anticipated costs. There will also be considerable changes to the required disclosures for contracts. The time and expense involved in developing this information could be significant.

The larger question is how complex contracts are to be separated into individual performance obligations. The most obvious concern relates to design-build contracts, which are popular precisely because services are bundled and integrated, rather than segmented. In addition, there are a number of unanswered questions regarding how these calculations would be affected by common industry practices, such as performance bonuses, change orders and post-completion warranty work.

Effective Dates

Both the lease accounting and revenue recognition standards were originally scheduled to be finalized during 2011, but the initial exposure drafts generated a large number of comments, triggering many significant changes.

In view of that, the FASB decided over the summer to reissue exposure drafts to allow for additional comments. As of now, indications are that both new standards will be finalized during 2012, with the lease accounting standard possibly going into effect in 2013 or 2014, and the revenue recognition standard in 2015 or 2016.

We will be closely monitoring the status of these standards in the months to come and will update you in coming issues of *Dimensions*.

Call us today at 314.862.2070 to discuss how you can prepare for upcoming GAAP changes.

Recent Case Provides Guidance on Section 199

A recent tax court case has shed some light on how to determine if certain receipts qualify for the Domestic Production Activities Deduction, commonly referred to as Section 199. The deduction can amount to a substantial sum - currently 9 percent of taxable income from qualified gross receipts - so it is an important issue to consider as part of your year-end tax planning.

The deduction was created by the American Jobs Creation Act of 2004 to encourage the creation of domestic jobs. To achieve this goal, Internal Revenue Code (IRC) Section 199 allows businesses to claim a deduction for a portion of taxable income from qualified gross receipts related to domestic production.

When initially enacted, the deduction was equal to 3 percent of taxable income from qualified gross receipts. It increased later to 6 percent and, beginning with the 2010 tax year, increased to 9 percent.

Claiming the Deduction

The term "qualified gross receipts" includes income generated by taxpayers engaged in the construction of real property, performed in the United States during the ordinary course of a construction trade or business. This raises the question of what is meant by "construction of real property," which is not defined in Section 199.

One recurring issue in IRS audits has been whether work on existing facilities amounted to substantial renovation - and thus was eligible for the Section 199 deduction - or whether the work should be classified as repair or maintenance work, which does not qualify for the deduction.

A 2011 tax court case, *Gibson & Associates, Inc. vs. Commissioner* (136 T.C. No. 10), provides useful guidance on these issues. The case involved a civil engineering and heavy construction contractor that performed mostly infrastructure work such as bridge renovations or expansions.

In deciding the case, the tax court established the precedent that an item of real property was inclusive of its various components and parts. In other words, the item to consider was each bridge that Gibson renovated, not each component part of that bridge.

Repairs or Renovation?

IRC Section 263 defines substantial renovation as work that materially increases the value of real property, extends its useful life, or makes the property suitable for new or different use. Gibson was able to provide extensive documentation that these projects met those criteria and were more than routine repairs.

The Gibson case is considered good news for contractors thinking of claiming the Section 199 deduction, since the court rejected the idea of breaking projects into pieces in order to classify some parts as repairs and others as renovation. It also clarified key definitions and provided guidance into important questions contractors should consider when determining which receipts qualify for the Section 199 deduction.

The IRS has raised Section 199 to a Tier 1 issue, meaning it is considered to be of "high strategic importance" and the IRS has an established legal position or prescribed guidance on it. So it is critical that you have clear documentation to support the Section 199 deduction, including what are qualified gross receipts and why. You should also have a well-prepared plan for allocating expenses to these receipts.

As you plan your year-end taxes, call us at 314.862.2070 for help in identifying potential deductions and the documentation you will need.

Don't Overlook Federal Fuel Tax Credit

Federal excise taxes on motor vehicle fuels are designed to help cover the cost of building and maintaining the federal highway system. If you operate diesel-powered off-road equipment, such as earth-moving machinery and other heavy equipment, be sure you aren't paying this road tax for fuel that is used for off-road purposes.

Fuel distributors collect a federal excise tax of 18.4 cents per gallon on gasoline and 24.4 cents per gallon on clear diesel fuel, but no tax is collected on diesel that is dyed red and intended for off-road use only. Virtually all large distributors are careful to distinguish between the two types of diesel. But if, for any reason, you end up using clear diesel in off-road equipment, you may be eligible for a refund of the federal excise tax you paid.

Generally, refunds of $750 or more may be claimed quarterly. Claims that are smaller than $750 per quarter may be claimed as a credit on your federal income tax return. In either case, you must have good records to support your claim. These records should show the number of gallons used, dates of purchase, names and addresses of suppliers and the amount bought from each, and the purposes for which the fuel was used.

Note that the refund is available only when clear diesel is used in machinery that is operated exclusively off-road. Moreover, you cannot claim a refund for clear diesel used in the engine of any vehicle that is registered for highway use, regardless of where the vehicle is actually used. Conversely, you may be subject to a substantial penalty if you use red dyed off-road diesel fuel in a highway vehicle.

If you have any doubt about how diesel fuel supplies are managed, talk to your fuel distributor or contact us at 314.862.2070 for more information.

For more information, please contact **Tony Smith, CPA** or **Teri Samples, CPA** at 314.862.2070 or tsmith@muellerprost.com or tsamples@muellerprost.com.