Tax Planning For Architecture And Engineering Firms

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Federal Tax Planning
How Is Taxable Income Or Loss Computed?
Most architectural or engineering firms use the cash method of accounting. This means that income is recognized for tax purposes when received, and expenses are deducted when paid.

Some firms use the accrual method of accounting. This means that income is recognized for tax purposes when the right to receive is fixed, and deductions are taken when the obligation is fixed and “economic performance” has occurred.
In order to understand what income is taxed, it is important to know that adjustments are made to “book” income to arrive at taxable income

- **Permanent differences**
  - Disallowed deductions for tax purposes - e.g., 50% meals, political contributions
  - Tax-exempt income

- **Timing differences**
  - e.g., different depreciation lives, treatment of leasehold improvements
Tax Planning For Capital Acquisitions
Leasing vs. Purchase

- Deductibility of lease payments vs. depreciation and interest expense (if financed)
- Cash flow considerations
- Capital lease (assets and liability reflected on balance sheet) vs. operating lease (transaction is off-balance sheet)
Tax Planning For Depreciation

- Accelerated depreciation available under MACRS

- 50% bonus depreciation gives big benefit — but assets must be placed in service by December 31, 2004

- Enhanced Sec. 179 expensing election through 2005 — up to $100,000 deduction allowed ($25,000 after 2005) on up to $400,000 of qualifying property purchased and placed in service ($200,000 after 2005)

- Must check each state’s rules, which may differ from federal treatment. Many states have opted out of bonus depreciation

- Reduced annual depreciation and limitation on leasing deductions for “luxury automobiles”. The maximum depreciation that can be claimed in any year is capped for “luxury automobiles”, and an offsetting inclusion in income must be made when lease payments for “luxury autos” are deducted.
Tax Planning Related To The Receipt Of Income
Deferral Of Income

► Because cash basis taxpayers do not recognize income for tax purposes until received, income can be deferred by delaying year end billing until the following year.

► But beware of “constructive receipt”. This doctrine requires a cash method taxpayer to recognize income when there is an unconditional right to immediately receive it. In other words, a cash basis taxpayer is not allowed to “turn his back” on income. Typically, this arises with checks received at year end, but not cashed until the following year.

► Deferral may not always be the best strategy. If a tax rate increase is anticipated, it may be better to accelerate income into the current year to take advantage of lower rates.
Receipt Of Stock Or Other Property For Services

- Where property is received for services, the fair market value of the property must be included in income, unless the right to the property is somehow restricted. Current taxation is imposed unless the property (typically stock) is both non-transferable and subject to a substantial risk of forfeiture.

- When stock that is traded on an established exchange is received, the value of the stock is easily established. However, when closely held stock is received, there must be some appraisal of the value, and certain discounts may be available.

- The receipt of a partnership or LLC interest in exchange for services can be structured so as to avoid the immediate recognition of income. In order to do so, the interest must be an interest solely in the future profits of the partnership, and must not be an interest in partnership capital. This means that, if the partnership/LLC were liquidated immediately following the transfer of the interest, the holder of the profits interest would not be entitled to receive any of the assets. Note that this tax-free receipt of an equity interest only works for a partnership or LLC (taxed as a partnership), and cannot be applied to the receipt of corporate stock (whether C or S stock).

- Tax savings can be achieved by receiving “phantom equity” instead of actual stock. This means that the firm gets a contractual right to the future appreciation of the stock of a client as if it were an equity owner without actual physical ownership of any stock. Phantom equity plans allow the income to be deferred until actually received. However, all income earned is taxed at ordinary rates as “compensation”, as opposed to capital gain treatment available on the sale or exchange of actual stock.
Tax Planning For Deductions
Prepayment Of Expenses

- Generally, all taxpayers must capitalize costs that generate a benefit substantially beyond the end of the taxable year of the expenditures.

- Recent Treasury regulations under Sec. 263 adopt the “12 month” rule initially established in the 9th Circuit case *Zaninovich*. Whereas the *Zaninovich* rule only applied to cash basis taxpayers, the regulations have extended the “12 month” rule to accrual taxpayers as well, as long as the expense would be otherwise deductible under the accrual method at time of payment (*i.e.*, the “all events” and “economic performance” tests have been met).

  - A taxpayer is not required to capitalize costs for any right or benefit that does not extend beyond the earlier of (i) 12 months after the date that the taxpayer realizes the right or benefit, or (2) the end of the year following the year in which the payment is made.

  *Example:* Cash basis taxpayer has an insurance policy with a term running from Dec. 1, 2004 through Nov. 30, 2005. If the taxpayer pays the full premium on Dec. 1, 2004, he may deduct the full premium in 2004, even though most of the benefit covers the 2005 year. However, the taxpayer could not deduct a payment in 2004 for more than one year, nor could he deduct in 2004 a payment for the one year period running from Feb. ‘05 through Jan. ’06.

  - The “12-month” rule means that taxpayers are not required to capitalize cost that qualify — but if capitalization is desired, it is still available.
Reimbursed Expenses

- No deduction is allowed when the firm advances costs on behalf of a client which the client is obligated to reimburse (so-called “hard” costs). Correspondingly, no income is recognized when the reimbursement is received.

- If such hard costs are advanced, but reimbursement cannot be collected from the client, the firm is allowed a bad debt deduction. Therefore, it is important to periodically review such receivables to determine whether a deduction is available. Indeed, all receivables need to be periodically reviewed for collectability.

- “Soft” costs, *i.e.*, costs that are not specifically billed to any particular client, may be currently deducted. Examples would be copying or secretarial costs.
Charitable Contributions Of Property

- Limitations are placed on the charitable deduction when tangible personal property, such as computers, are donated to charity and used for a purpose unrelated to the purpose constituting the basis of the organization’s charitable exemption. In such case, the deduction is equal to the lesser of the tax basis of the property or its value. If the use is related, which is a factual determination, then a deduction is allowed for the full fair market value.

- In addition, if depreciation deductions have been claimed, or if the property is held for less than one year, the charitable deduction must be reduced by the ordinary income (short term gain) element.
PENSION ISSUES:

What Type Of Pension Plans Does Your Firm Currently Offer?
Pension Plans

- Qualified plans allow current deduction to employer without current income to participants. Participants are only taxed when distributions are received. Income earned on contributions is not taxed until distributed. However, stringent rules apply, such as nondiscrimination.
  - **Defined contribution plan** is a plan that provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant’s account, and income allocated to the account. Examples are profit sharing or 401(k) plans.
  - **Defined benefit plans** are plans other than individual account plans, such as pension plans.
Nonqualified deferred compensation plans allow deferral of compensation to participants, but employer deduction is also deferred. Under Treasury Revenue Procedures (Rev. Procs. 71-19 and 92-65), deferred treatment will be assured (i.e., no constructive receipt) if the taxpayer elects to defer by the end of the year before the year in which the compensation is earned (case law is more liberal). Also, to avoid constructive receipt, the employer assets from which the deferred compensation will be paid must be subject to the reach of the employer’s creditors (for example, in a Rabbi Trust). Note that although the compensation is not subject to income tax until received by the participant, it will be subject to FICA when deferred.

Phantom equity plans are an alternative means of giving employees a right to participate in the company’s appreciation and future profits without issuing actual equity. A phantom equity plan is a deferred compensation plan which gives the participants a contractual right to share in profits and appreciation. But when received, the full amount is taxed at ordinary rates as compensation.
State And Local Tax Planning
Who Needs To Be Concerned

- Multiple office firms
  - I already file in 5 (10,15) states

- Single office firms
  - Why file anywhere else
  - I am only licensed in New York, New Jersey, ....
Every time the state coiffeurs run dry — the taxing authorities are looking for the ____________.

“We are going to methodically schedule ____________... it's not a question of if we are going to get you but merely a question of when.”

James Wetzler, Commissioner of the State Department of Taxation and Finance July 1988.
The __________ community has the worst income tax compliance record of any profession.

Officials attributed the low compliance rate to the fact that partnership income is not subject to withholding.

The greater the distance from New York State, the greater the likelihood a partner had not filed a New York return.
While many states have tax regulations that call for taxation of any individual who performs professional services (and earns income) in a state, many states do not spend their administrative dollars administering the tax on the typical nonresident. The professional activities performed by athletes are more in the public eye than services of many professionals, and the exposure probably contributes to the additional administrative efforts.
The Invisible Telecommuter

- Does this create an office in a state where the firm is otherwise not doing business?
- Most states have not directly addressed this issue
- Federal legislation has been proposed to address this issue
Don’t States Have Minimum Filing Thresholds?

- In a recent survey of 25 States
  - 18 said there is no threshold
  - Others ranged from $750 to $3,300
Additional Filings May Not Mean Additional Tax

- Credit for taxes paid to other state
  - A resident taxpayer claims a credit against his or her resident state income tax
    - for any income tax paid to a nonresident state
    - with respect to income derived from the other taxing jurisdiction
    - that is also subject to the resident state’s personal income tax
Limitations on the Credit

- The credit may not exceed the percentage of the tax otherwise due, determined by dividing the portion of the taxpayer’s resident state income subject to taxation by the nonresident jurisdiction by the total amount of the taxpayer’s resident state income.
- The credit may not reduce the tax below the amount of tax which would have been due if the income subject to taxation by the other jurisdiction were excluded from the taxpayer’s Resident State income.
- The credit only applies to items of income that are sourced (e.g., earned) in the nonresident state.
- The credit is available only for the year the tax is imposed by the other jurisdiction, not the year the amount is actually paid.

Generally those who are resident in high tax jurisdiction states will be “made whole” by the credit as it relates to earned income. Those resident in low or no income tax states will be hurt by the nonresident filing requirements.
Do I Really Have To File My Own Return In Every State?
Most states permit the filing of a composite return

- The partnership will file the return on behalf of the eligible nonresident partners
- **Price for filing a composite return:**
  - generally no deductions or exemptions
  - tax paid at the highest state rate
- **Savings for filing a composite return:**
  - partners don’t need to file a multitude of returns
  - only need to report the state sourced income and not the partners’ worldwide income
In order to qualify

- a partner must consent to be part of the composite filing

- a partner must generally consent to give up his deductions and/or exemptions and pay tax at the highest graduated rate

- a partner must have no other source of income from the state in which the composite return is being filed
States Step In To “Help” Nonresidents Partners

- New and improved withholding tax schemes spreading throughout the country
  - New Jersey – enacted during 2002
  - New York – enacted during 2003
  - Connecticut – enacted during 2004
- Partnerships (and other flow-through entities) are now required to withhold and remit tax to the state on behalf of the nonresident partners (members, shareholders …)
Exemptions To Withholding Requirements

NEW YORK
- Certificate of Exemption
  - Completed by partner and remitted to the partnership
  - Expires every few years

NEW JERSEY
- None
- “Under the statute the state is to receive the float on these payments”

CONNECTICUT
- Group return
- Composite return

Either way the partnership will end up remitting the tax for the nonresident partners
NYC Unincorporated Business Tax Basics (UBT)

- The Unincorporated Business Tax is a tax imposed on the unincorporated business taxable income of every unincorporated business carried on wholly or partly in New York City.

- Rate of Tax
  - The tax is imposed for each taxable year at a rate of 4% of unincorporated business taxable income.
Major Exemptions From The UBT

- Self trading exemption
- Exemption for holding, leasing or managing real property
Methods Of Allocation

- Taxpayer’s Books and Records
- Statutory Allocation Formula
- Other Methods
Major Modification From Federal Taxable Income In Computing UBT Income

- Amounts paid or incurred to a proprietor or partner for services or for use of capital
  - e.g., Salaries, commissions, consultant fees or professional fees paid to a general or limited partner for personal services rendered by the partner, either as an employee or an independent contractor of the unincorporated business, may not be deducted by the partnership

- A sole proprietor who does his own bookkeeping, billing and other administrative services may not deduct the cost of his time and skill in providing such services
When Is A Partner Not A Partner
Or Sometimes A Partner?
Retired Partners

Buchbinder Tunick & Co. v. Tax Appeals Tribunal of the City of New York

Payments to retired partners were not deductible in computing New York City unincorporated business tax.

- The Court of Appeals overturned the decisions of the Appellate Division in reaching its decision.
Special Partners

In the Matter of the Petition of Ladas and Parry

Payments to Special Partners were deductible in computing New York City unincorporated business tax.

- The Special Partners were listed as partners on Petitioner’s letterhead and in its listing in the Martindale-Hubbell Law Directory.

- The definition of partnership is determined by the totality of the facts and not a firm’s decision to label an individual as a “partner”.
  - No equity interest in the partnership
  - No capital contribution
  - No share in the losses
  - No right to examine the books or manage partnership affairs
  - The special partners consistently treated themselves as employees for purposes of their personal income taxes. (They received a W-2 and not a K-1).
Appeal of Frederiksen,
98A-0162, (California State Board of Equalization, Jan 7, 1999) (SBE Decisions may not be cited as precedent)

Non-equity Partners May Not Have To File Non-Resident Returns

- Frederiksen accepted an offer from an international law firm’s Texas office.
- The offer letter specified that Frederiksen:
  - was not joining the firm as an “equity partner,”
  - will receive a guaranteed base compensation, plus a performance based bonus at the discretion of the Management Committee of the firm;
  - had no responsibility for the debts or obligations of the firm;
  - was not entitled to share in the earnings and profits;
  - had no vote in the management of the firm; and
  - the firm reported his compensation by way of a partnership K-1, which identified him as a “limited partner” and reported his compensation as “guaranteed payment to a partner.”
The SBE held that:

- Frederiksen was not a partner
- income was for professional services
- the income is “sourced” to the place where the services were performed; in this case, Dallas, Texas
- appellant has no California source income, and, as a non-resident, has no California tax filing requirement
Sales And Use Tax Issues

- **Period of Audit**
  - Generally three years from date sales tax return filed
  - If no return filed, no statute of limitations, but New York State will generally limit to six years
Income

- **Architectural and Engineering services by a licensed professional** – not subject to tax
  - NYC – Interior Design services are subject to tax

- **Client disbursements** — incidental to the provision of services — not subject to tax
Fixed Asset Purchases

- Generally, all purchases for audit period examined

- Areas of possible exposure:
  - capital improvements
  - out-of-state purchases
Recurring Expense Purchases

- Generally done on a test basis
- Taxpayer has right to protest audit results where audit done on a test basis
- Areas of possible exposure:
  - computer hardware and software
  - out-of-state purchases
  - books and periodicals
Documentation Required During Audit

- Capital improvement
  - Contract or other description of work performed

- Periodicals
  - Invoice describing length of subscription
  - Copy of periodical

- Reimbursements to employees for purchases made
  - Obtain copy of original invoice — not just credit card receipt
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Thank You

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