Volume 7 | Issue 1 | 2013

construction & real estate industry advisor

The Financial Side of the Construction & Real Estate Industries

IN THIS ISSUE

Katz, Sapper & Miller, LLP
Certified Public Accountants

By Douglas Rubenstein, CPA
Director
Tax Department
drubenstein@ksmcpa.com

The Affordable Care Act and the 3.8% Medicare Tax

In December 2012, the Internal Revenue Service (IRS) issued proposed regulations that expand upon the Patient Protection and Affordable Care Act of 2010 (Affordable Care Act). One of the provisions of the Affordable Care Act is Code Section 1411, Unearned Income Medicare Contribution Tax. The new law and proposed regulations may affect the real estate and construction industries, as certain individuals may have an additional tax liability, depending on their income.

Effective Jan. 1, 2013, certain individuals, trusts and estates will be required to pay a 3.8% Medicare tax on their share of net investment income. Net investment income includes interest, dividends, royalties, annuities, capital gains, rents, and income from passive trade or business activities.

The additional Medicare tax will be imposed on individuals, trusts and estates with modified adjusted gross income in excess of the following income amounts:

- Married Filing Joint or Surviving Spouse – $250,000
- Married Filing Separate –$125,000
- Single and Head of Household – $200,000
- Trusts and Estates – $11,950

The tax will be calculated on the lessor of the net investment income or total modified adjusted gross income in excess of the threshold amounts listed above.

How will the new law and proposed regulations specifically apply to the real estate and construction industries?

Passive Activities

If an individual, trust or estate owns rental activities and/or trade or business activities that are considered passive under Code Section 469, then the combined net income from these passive activities would be subject to the 3.8% Medicare tax if the taxpayer's modified adjusted gross income is in excess of the appropriate threshold listed above.

The determination of whether the income or loss from a trade or business or rental activity from a partnership or S corporation is a passive activity is determined at the partner or shareholder level. Prior year suspended losses from passive activities may be utilized to offset current-year passive income subject to the Unearned Income Medicare Contribution Tax.

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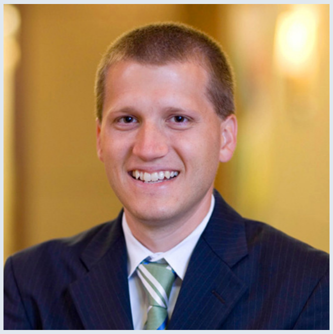
Updated Proposed Accounting Rules for Leases



By Michael North, CPA
Director
Audit and Assurance Services Department
mnorth@ksmcpa.com

No accounting issue in recent memory has been in discussion longer and more highly anticipated than the Financial Accounting Standard Board's (FASB) and International Accounting Standards Board's (IASB) leasing convergence project. On May 16, 2013, the FASB and the IASB, also known as "the Boards," released nearly identical, revised exposure drafts that call for a dual-recognition approach to the recognition, measurement and presentation of expenses and cash flows arising from leases. Lessees would recognize assets and liabilities on their balance sheet for leases of more than 12 months. Re-exposing the revised proposals will provide interested parties with an opportunity to comment on revisions the Boards have undertaken since the publication of the original exposure draft released Aug. 17, 2010.

The proposals are available at the Boards' respective websites, fasb.org and ifrs.org. Comments are sought by the public through Sept. 13, 2013. Although it is not clear when these new rules will be effective, a transition period for applying them could extend until 2017 for privately held companies.

The FASB has stated since the beginning of this convergence project in 2009 that lessees should be required to capitalize leases on their balance sheets as assets and liabilities, and that has not changed with this recent exposure draft. The biggest area of contention and change over the past few years has been whether lessees should record expenses differently for equipment leases versus property leases. In the FASB's recently released exposure draft, they continue to hold that all lease arrangements would apply what they call a "right-of-use model." Under this model, a lessee in an arrangement that is, or contains, a lease would recognize an asset representing its right to use an underlying asset during the lease term and a liability representing its obligation to make lease payments during the lease term.

New Expense Recognition for Lessees
Changes since the original exposure draft pertain to how the expenses related to leases should be recognized. The FASB concluded that some leases will result in expenses using an interest and amortization approach and some resulting in a straight-line lease expense approach. Leases for equipment should use the interest and amortization method unless:

1. The lease term is an insignificant portion of the economic life of the underlying asset, or
2. The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

Under the interest and amortization method, lessees would report amortization of assets separately from interest on the lease liability for leases during which consumption of more than an insignificant portion of the asset occurs. This type of lease would be recognized as a nonfinancial asset measured at cost, less amortization. This would result in a total lease expense

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By Tim Cook, JD
Partner
State & Local Tax Practice
tcook@ksmcpa.com

The Tiff Over TIFs

Tax Increment Finance districts, or TIFs, have been around for a long time. They work this way: A boundary line is drawn around an area of property. This area can be a single parcel, or it can extend for blocks and blocks. A snapshot is taken of the property taxes paid within the TIF at the time the district is established. Then, bonds are issued based on the new incremental property taxes resulting from the increase in assessed value that occurs within the TIF after its establishment date. These proceeds then can be used for infrastructure and other development initiatives within the TIF.

Like all legislative creations, approving bodies and prospective beneficiaries continue to develop creative ways to employ TIFs. And there is the rub. With these new methods of utilizing TIF funds come sporadic community skirmishes over the use of TIFs.

> The concept of TIFs, and even the very name itself, has become a shorthand attack on economic development projects.

On occasion, the concept of TIFs, and even the very name itself, has become a shorthand attack on economic development projects. This is especially true in pockets of Central Indiana – in Indianapolis where the mayor and City County Council are at an impasse over several large projects reliant on TIFs, and in Hamilton County where TIFs have been under fire in recent years.

The use of TIFs is a legitimate public policy topic. A TIF involves the redeployment of property taxes and thus merits scrutiny. But to ensure that the discussion is a thoughtful one, it is important that facts, not conjecture, ground the debate.

Some argue that a TIF should never be used to spur private development because it will divert property taxes from their intended uses. Yet, these detractors sometimes support property tax abatement for the same project within the same TIF district. In these instances, the property taxes are being diverted regardless – one diversion happens to be called a TIF, the other tax abatement. With a TIF, a community knows precisely where and how the property taxes will be spent, since the TIF's Redevelopment Commission must pre-approve the expenditures. In contrast, with tax abatement the benefit is an offset to future taxes to be paid, with no restrictions on how the savings are deployed.

Another misleading argument about TIFs is that they are used to support projects that were going to happen anyway. This point may or may not be true, but that same point applies to any economic development program that these same detractors support. While the use of incentives is a legitimate topic for debate, the "but for" test applies the same to a tax credit or training grant as it does to a TIF. In other words, would the project have come to fruition but for the TIF?

In contrast, a TIF is not a magic elixir for every economic development opportunity. It has potential to make a good project viable, but it can never make a bad project good. TIF supporters need to heed those cautions founded on substance and concern for a project's long-term prospects.

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By Thomas Nowak, CPA
Director
Business Advisory Group
tnowak@ksmcpa.com

Maintaining Your Ability to be "Bond Worthy"

In today's economy, risk-averse project owners are more likely to require bonds. At the same time, there are fewer sureties in business, and those who are still active have become more rigorous in their evaluation and approval of bond requests. So it is critical for contractors to show that they are "bond worthy." The following are five tips for doing just that.

1. Make a Strong Statement
Companies may be financially healthy, but if they cannot demonstrate this to a surety, obtaining bonds will be a challenge.

Make sure financial statements are consistent, complete, accurate and timely, and provide other documentation as needed, such as owners' personal financial statements. Also, minimize year-end adjustments by preparing high-quality interim financial statements, including entries for monthly depreciation and work-in-process changes.

2. Manage Profits and Net Worth
A critical indicator for a surety is a company's profitability. So manage the factors that affect profitability, such as overhead costs and bonuses.

A company's net worth provides evidence of its ability to absorb losses. But sureties also look "behind" this number at the quality of the underlying assets. They may discount the value of riskier assets, such as aged receivables and inventory. Cleaning up the balance sheet by removing risky assets and reinvesting profits in the business can help boost bonding capacity.

3. Work the Working Capital
Sureties want to see strong working capital, which is defined as current assets minus current liabilities. Current assets include cash and assets readily converted into cash, such as short-term receivables and certain inventory. In contrast, illiquid assets may include facilities and equipment.

In measuring working capital, sureties typically discount riskier assets, such as aged or related-party receivables or prepaid expenses. To improve working capital, consider accelerating collection of receivables, deferring payment of year-end bonuses or other expenses, or refinancing short-term debt with long-term debt.

Quality of working capital (and all assets) matters. Consider liquidating or eliminating non-core or related party assets to remove lingering doubts regarding the value of such assets. Contractors commonly use a bank line of credit for short-term borrowings to help meet the cash flow demands of weekly payrolls, slow paying clients and retainages. It is important for a company to demonstrate to a surety that its line of credit availability extends beyond the particular bonded jobs. It is important to communicate with the surety and lender to meet these expectations.

4. Track Progress
"Profit fade" (where a contractor's gross profits shrink over the course of a project) will undermine a surety's

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See "Bond."

By Jolaine Hill, CPA
Director
Tax Department
jhill@ksmcpa.com

Section 263A: Uniform Capitalization Rules

The Uniform Capitalization (UNICAP) rules of Section 263A of the Internal Revenue Code (IRC) prescribe the method for determining the types and amounts of costs that must be capitalized rather than expensed in the current period. The UNICAP rules apply to those who, in the course of their trade or business, produce real property for use in the business or activity; produce real property for sale to customers; or acquire property for resale. ("Produce" means to construct, build, develop or improve property.)

Section 263A is significant for the real estate industry, and it is specifically important for land developers and large homebuilders whose average annual gross receipts are more than $10 million and contracts are in excess of two years. For construction contractors using the percentage of completion method under Section 460, the regulations under Section 460 mirror the regulations under Section 263A.

The UNICAP rules require a taxpayer to capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale.

- Direct costs are defined as the direct material costs and direct labor costs for a contractor or large homebuilders and the acquisition costs for a land developer.
- Indirect costs are defined as all costs other than those considered direct material costs and direct labor costs or acquisition costs. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of construction or development activities.

Indirect costs can be categorized into two groups: those that must be capitalized and those that are allowed to be expensed in the current period. Indirect costs allowed to be expensed in the current period include marketing, selling, advertising and distribution expenses; general and administrative expenses not related to construction or development; officers' salaries that are not related to construction or development activities; research and experimental expenses; as well as depreciation and amortization.

A taxpayer that produces property must capitalize all costs incurred before, during and after the construction or development of the property. Pre-construction and pre-development costs must be capitalized, including the carrying costs, real estate taxes, and costs of zoning requests related to the holding of realty for future development. Construction and development period costs are those costs that fall between the date on which construction or development begins and construction or development ends. Construction or development is deemed to have ended once the property is placed in service or ready for sale. Any costs incurred after the construction or development would be considered post-construction or development costs. Interest, however,

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By Alyson Lurker, CPA, JD
Manager
Tax Department
alurker@ksmcpa.com

The Research Credit and the Construction Industry

The Credit for Increasing Research Activities – commonly known as the R&D credit – is intended to serve as an incentive to develop new and improved products and/or processes. Taxpayers typically envision the research credit applying only to product manufacturers, drug manufacturers, and the like. However, the credit is currently available to any taxpayer that participates in qualified research activities and has qualified research expenses paid or incurred on or before Dec. 31, 2013. This includes taxpayers in the construction industry.

Qualifying activities in the construction industry may include build-design services, architectural and engineering services, design concepts, CAD drawings, schematic designs, geographical testing, on-site construction changes, or many other related activities.

To determine whether or not a taxpayer has qualified research, they must be engaged in qualified research.

Qualified Research Defined: A Four-Part Test

The definition of "qualified research" contained in the Internal Revenue Code Section 41 provides a four-part test for determining whether activities constitute as qualified research. The activity must meet all of the following requirements in order to qualify:

1. The cost of the activity must be deductible research and experimental expenditures under Code Section 174 (i.e., eliminate uncertainty).
2. The activity must be undertaken for the purpose of discovering information, which is technological in nature (i.e., rely on engineering, computer science, etc.).
3. The application of the technological information must be intended to be useful in a new or improved business component (i.e., product or process).
4. Substantially all of the activities related to the research effort must constitute elements of a process of experimentation (i.e., testing and evaluating alternatives).

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See "R&D."*

Medicare

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Rental Recharacterization Rules

Treasury Regulation 1.469-2(f) (6) states that an amount of the taxpayer's rental activity income from an item of property is treated as a non-passive activity if the property is rented for use in a trade or business in which the taxpayer materially participates. This is also known as the self-rental rule. For example, ABC Construction Company, an S corporation owned by two individuals, rents a building that is owned in a partnership entity by the same two individuals. The rental real estate income earned by the partnership would be subject to the rental recharacterization rules, and, therefore, the net rental income would be considered non-passive for federal income tax purposes. However, if the partnership entity incurred a net rental loss, then the loss would be subject to the passive activity limitations.

It is not clear in the proposed regulations when net rental income earned under the self-rental rules is subject to the Unearned Income Medicare Contribution Tax. The proposed regulations state that property rented to a non-passive activity, will in most cases be subject to an additional 3.8% tax if the rental income is not derived in the ordinary course of business. Whether a self-rental activity qualifies as derived in the ordinary course of a trade or business will be based on the facts and circumstances of each case.

There may be several possibilities in which the rental activity could qualify as being derived in the ordinary course of a trade or business. One example may be when employees are actively involved in collecting the rents, making repairs, providing services to the tenant, and pursuing third-party tenants.

Grouping Rules

Treasury Regulation 1.469-4 allows for the taxpayer to treat two or more business activities or rental activities as a single activity if the activities constitute an appropriate economic unit (AEU). The grouping of activities as a single activity is based upon a facts and circumstances test. The grouping rules are important as they allow for the material participation rules to be applied to the group instead of each individual activity. There are certain limitations to the grouping rules and one limitation is a rental activity generally cannot be grouped with a trade or business activity.

The IRS issued Revenue Procedure 2010-13, which provided guidance for initial grouping of activities, regrouping of existing activities and addition of activities to existing groups. The revenue procedure is effective for tax years beginning on or after Jan. 25, 2010, generally Jan. 1, 2011, for calendar year taxpayers. Once the activity groupings are established, they cannot be changed unless the groupings

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See "Medicare."

INCOME TAXED

The additional Medicare tax will be imposed on individuals, trusts and estates with modified adjusted gross income in excess of the following income amounts:

Married Filing Joint or Surviving Spouse
$250,000

Married Filing Separate
$125,000

Single and Head of Household
$200,000

Trusts and Estates
$11,950

The tax will be calculated on the lessor of the net investment income (interest, dividends, royalties, capital gains, etc.) or total modified adjusted gross income in excess of the above threshold amounts.

Medicare

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are inappropriate or there is a material change in the facts and circumstances that would cause a change in the groupings. In addition, any changes must comply with the disclosure requirements as prescribed by the Commissioner of the IRS.

The Treasury Department and the IRS have determined that taxpayers who meet the applicable income thresholds for the Unearned Income Medicare Contribution Tax should have the opportunity to regroup their activities. Therefore, the proposed regulations provide taxpayers with the opportunity to regroup their activities in the first taxable year beginning after Dec. 31, 2013. For calendar year taxpayers, it would be effective for the Dec. 31, 2014, tax year. Taxpayers would have the option to rely on the proposed regulation and regroup their activities, during calendar year 2013 if the Unearned Income Medicare Contribution Tax would apply. This is a one-time opportunity for clients to regroup activities and, once the regrouping is complete, it would apply in all subsequent years.

As noted, these are proposed regulations and could be subject to change in the near future. Any changes prior to the finalization of the regulations could have an impact related to a taxpayer's income tax liability. ■

Leases

(Continued from page 3)

that generally would decrease over the lease term. This approach would be used for most equipment and vehicle leases. The concerning part of this approach for lessees is that this will likely result in accelerated expense recognition for lessees compared to operating leases under current authoritative guidance.

Under the proposed standards, lessees will use the straight-line approach and report straight-line lease expenses in their income statement for leases when a lessee pays for only the use of the asset and the lease does not consume a more than insignificant portion of the asset.

This straight-line approach would be used for most property leases.

Lessors

The updated proposals by the FASB also created a dual accounting approach for lessors. When the lessee does not have a right to acquire or consume more than an insignificant portion of the underlying asset (typically presumed for leases of property), the lessor will apply an approach similar to current operating lease accounting. When a lease gives a lessee the right to acquire or consume more than an insignificant portion of the underlying asset (typically presumed when the underlying asset is equipment), the lessor will apply the receivable and residual approach.

Under the receivable and residual approach, the lessor, at lease commencement, will:

- Derecognize the entire carrying amount of the leased asset.
- Recognize a receivable measured at the present value of the remaining lease payments, discounted at the rate the lessor charges the lessee.
- Recognize a residual asset, measured as an allocation of the carrying amount of the underlying asset. This comprises a gross residual asset and a deferred profit on that residual asset.

These proposed lease accounting rules are complicated and are still only proposed standards. Interested parties need to continue to follow these developments, and, as the final rules become clear, begin to focus on how best to implement these standards. The FASB has listened to the industry throughout this four-year process and continues to make changes based on industry voices. If you would like to comment on these latest proposed rules, that opportunity is currently available through September 2013. ■

The FASB has listened to the industry throughout this four-year process and continues to make changes based on industry voices.

TIFs

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Additionally, because a TIF is an upfront incentive versus performance-based, a project's failure poses more risk to the locality. Consequently, greater upfront scrutiny is appropriate. TIF projects touted as win-win, public-private partnerships need to demonstrate their economic development promise in terms of tangible benefits to that community.

TIFs will remain viable only as long as constituents can look back on a project long after the fact and point to practical evidence that the community made a good investment. Then, and only then, may skeptics and critics finally concede that TIF is not a four letter word. ■

Bond

(Continued from page 5)

confidence in a company's financial strength. It can signal a number of weaknesses, including inaccurate estimating and poor project management. Even profit *gain* can cast doubt on a company's estimating abilities.

Sureties also examine under billings (billings that lag behind a job's progress), which may point to cost overruns, inefficient management or lax billing practices. Overbilling can reflect effective cash management, but it can also be a sign of "job borrowing" — that is, overbilling on some projects to compensate for fading profits on others.

To instill confidence in a surety, prepare timely, accurate work-in-progress reports to help stay on top of estimating and project management processes and correct problems as early as possible.

5. Prevent Surprises

For sureties, there is one thing that is worse than bad financial news, and that is bad financial news that they were not expecting. For instance, what if an owner or key employee dies, becomes disabled or suddenly retires? Make sure to have a well-designed succession plan and strong management team to provide assurance that long-term prospects are strong.

Additionally, to increase a surety's comfort level, maintain ongoing communication regarding any developments that are affecting financial performance. Doing so not only helps demonstrate good intentions, but also gives companies an opportunity to explain any financial difficulties and outline plans for turning things around.

Beyond Bonding

Along with boosting bonding capacity, these strategies can produce other significant business benefits, including making construction companies more attractive to lenders and investors. ■

Capitalize

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only needs to be capitalized during the construction or development stage.

There are various methods that can be used to allocate the direct and indirect costs to the property produced. Depending on the taxpayer's needs and type of construction or development, one of the following methods can be used:

- A specific identification method, where costs are traced to a cost objective – a specific contract, for example – on the basis of a cause and effect or other reasonable relationship between the costs and the specific contract.
- A burden rate method, where indirect costs are allocated based upon a ratio, such as labor hours, to the contract using predetermined rates that approximate the actual amount of indirect costs incurred.
- A standard cost method, where direct and indirect costs are allocated to the contract through the use of pre-established standard allowances, without reference to actual costs incurred. Any significant variances would need to be reallocated.

The updated UNICAP rules will affect many contractors and land developers as many of the costs that were previously deductible as period costs are now accumulated and allocated between the contract or development costs and current period costs. The UNICAP rules also delay the expensing of capitalized costs, which ultimately results in the acceleration of taxable income. ■

Section 263A is significant for the real estate industry, and it is specifically important for land developers and large homebuilders.

R&D

(Continued from page 7)

Certain activities are specifically excluded from the definition of qualified research. Examples of activities that are excluded, but not limited to, are:

- Research conducted after the beginning of commercial production
- Research related to the adaptation of an existing business component to a particular customer's requirement or need
- Research related to the reproduction of an existing business component from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component
- Any efficiency survey
- Activity relating to management function or technique
- Market research, testing or development (including advertising or promotions)
- Research funded by another person or governmental entity

Qualified Research Expenditures Defined
The term "qualified research expenditures" means the sum of the in-house and contract research expenses, which are paid or incurred during the taxable year in carrying on a trade or business. "In-house" expenses include:

- Qualified wages, are wages paid to an employee for performing qualified research, directly supervising or supporting qualified research.
- Qualified supplies, which are defined as any tangible property other than (1) land or improvements to land, and (2) property of a character subject to the allowance for depreciation. Extraordinary utilities may also qualify. Supplies do not include meals, entertainment, travel, or overhead.
- Qualified computer leasing costs.

A contract research expense is generally 65 percent of any amount paid or incurred by a taxpayer in carrying on his or her trade or business to any person other than the taxpayer's employee for the performance of qualified research or services, which, if performed by employees, would constitute qualified services.

Contract research expenses qualify only if paid or incurred pursuant to an agreement that is entered into prior to the performance of the qualified research and that a company has the rights to the research results and agrees to bear the expense of the research regardless of the success of the research.

State Research Credits
Indiana also provides a 15 percent research credit (for the first $1,000,000 in qualified research expenditures and then 10 percent credit for those expenses beyond the $1,000,000) that is defined and calculated similarly to the federal research credit. The Indiana credit is only available for research conducted within Indiana and is available to a company regardless of its apportionment.

Other states offer research credits as well. Please check with your KSM advisor if you perform research activities in other states. ■

The credit is currently available to any taxpayer that participates in qualified research activities and has qualified research expenses paid or incurred on or before Dec. 31, 2013.

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