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Construction Accounting and Taxation

Keeping The Doors Open: Two tax incentives for the construction industry that will grow your business and stabilize your future

BY DEAN ZERBE, alliantgroup National Managing Director and
LINDA MCCLUSKEY, alliantgroup Managing Director - Energy Credits and Incentives

As the U.S. economy has experienced a substantial decline in recent years, many startups and small to mid-sized businesses have struggled to increase growth or maintain current revenue and sadly, for some, doors have permanently closed. While many small to mid-sized firms continue to struggle, larger companies have improved their bottom line by taking full advantage of lucrative tax credits and deductions that in many cases are readily available for small and mid-sized businesses.

The Research and Development (R&D) Tax Credit and the Federal Energy Efficient Commercial Building Tax Deduction (179D) are two of these very viable and lucrative tax benefits for small and medium-sized construction firms seeking financial relief. These incentives were created by Congress to not only encourage innovation and business growth, but to ultimately strengthen our economy as a whole. As 70 percent of all Americans are employed by small to mid-sized businesses, the fate of these companies is undeniably intertwined with the U.S. economy; any benefit that could help these businesses succeed would in turn, push the economy forward. Investment in smaller and mid-sized firms within the construction industry is in the interest of our nation as a whole. However, in order for these tax benefits to help small and mid-sized construction companies, these businesses must finally opt in and apply, which unfortunately is a task that many firms have simply failed to do in the past.

R&D: Background and Benefits

Commonly misunderstood ***(and perhaps the most powerful tax incentive available to constructors)*** is the R&D tax credit. Only one in 20 small to medium sized businesses eligible for the R&D tax credit actually apply for it. For the majority of constructors who have been unknowingly missing out, the time to capture full government-endorsed tax credits is now.

For example, a construction company with annual sales of $25 million developed the means and methods to improve two boilers in a medical center, including the associated piping. The two boilers increased the efficiency of the building. During the installation, the hospital required that the boilers be operational at all times to maintain the functionality of the hospital.

The company designed a temporary system and associated piping so one existing boiler could be removed and replaced at a time. Because this company pursued developments to improve the efficiency of the building in question, they were awarded over $325,000 in federal R&D tax credits. Luckily, this company recognized the potential benefit offered through the R&D tax credit and received huge tax savings from basic improvements.

"The most dangerous thing they can do if they are struggling is self-censor and ignore what could be a source of funds that can help them grow their firm and continue to remain competitive," said James Frankel, alliantgroup client and Senior Partner at Arent Fox.

The R&D tax credit was introduced by Congress in the 1980s and was primarily for biomedical and technological research. Since that time however, the definition of what qualifies as R&D has expanded significantly and now encompasses many industries, including construction. When companies think of activities qualifying as research and development they often think of people in white lab coats creating completely new products and invention developments. In reality, smaller companies are improving products and processes on a daily basis and could also be claiming valuable, government-endorsed tax incentives for work they are already doing. While big businesses are taking the R&D tax credit, small to medium sized companies are assuming they don't qualify and leaving money on the table.

In light of many recent events, the R&D tax credit has actually become more attainable to small and mid-sized businesses like never before. Changes in the treasury regulations in 2001 – underscored by three major court rulings in 2009 have in fact significantly loosened the restrictions on and expanded the definition of what constitutes research and development activities. Court decisions in both ***U.S. v. McFerrin,*** and ***FedEx Corp v. U.S.,*** highlighted that the 2001 change in treasury regulations rolled back the outdated "Discover Test" restrictions, providing that the only innovations in research businesses needed to prove was a substantial and economically significant reduction in cost or improvement in speed-- rather than ***"knowledge that exceeds, expands, or refines the common knowledge,"*** in the industry. In short, your work has to be ***"new to you," not "new to the world."*** This removal of the discovery test is extremely business-friendly and is a key reason why the R&D tax credit is the largest business tax credit provided by the federal government – nearly $10 billion dollars a year.

Additionally, ***U.S. v. McFerrin*** allowed for oral testimony and the institutional knowledge of employees as evidence of research under the R&D tax credit. This allowance for oral testimony and institutional knowledge has been of significant help to taxpayers with less-than-perfect-records to still be able to qualify for the R&D tax credit. In another win for taxpayers looking to take advantage of the R&D credit, the court ruling in ***TG Missouri Corp. v. Commissioner*** provided that molds and prototypes used for production, if not depreciable by the taxpayer, are eligible for the R&D credit. The court ruling in ***TG Missouri*** has made it easier for companies to also look at certain supply costs as also counting for the R&D tax credit.

A nice bonus is that approximately 40 states now have a state R&D tax credit as well – so your business in applying for the R&D tax credit can often look to not only reducing your federal tax bill but also your state tax bill.

The expanded legal definitions for innovation and research are a major win for the construction industry as a whole because the industry involves constant innovation—not only for its own benefit, but also to meet the needs of the many diverse enterprises. Construction firms must begin taking advantage of the R&D tax credit to receive the incentives they deserve for work they are already doing on a daily basis. This credit encourages the kind of innovation and growth that ought to be present in the construction industry to keep U.S. businesses strong and prosperous.

Qualifying for R&D

Qualifying activities are aimed at developing the construction process for specific jobs or those intended to improve the overall process performance in order to increase efficiencies. Design/build services, LEED projects, and value engineering are often the best candidates, but even some pre-construction planning and development of means and methods for plan-spec and hard-bid jobs qualify for the benefits. Since this incentive is an enticing dollar-for-dollar reduction in tax liability, even a small portion of activities that qualify can result in significant tax benefits. If your company has invested time, money, and resources toward the advancement and improvement of designs and processes, then you most likely meet the requirements for the R&D tax credit.

Firms of all sizes qualify for this credit. For example, a smaller company who is a provider of construction management, design/build, and general contracting solutions undertook detailing and fabrication projects to develop structural details for a variety of projects. During the process, the company commenced structural detailing and fabrication projects for new buildings, building renovations, and building additions. Because of unique site requirements, municipal codes, and client requirements, the company was also required to develop design solutions that were new or improved with respect to function and performance.

As a result of the design uncertainties faced at the outset of each project, the company undertook a process of experimentation to meet project requirements. Specifically, they conducted a systematic process through multiple phases to develop conceptual through detailed designs that achieved acceptable function and performance. During the subsequent design phases, schematic design and design development, the firm refined the program and concepts and delivered plan and elevation drawings that represented the final design of the projects to be issued for construction. Consequently, this company was rewarded substantially in federal R&D tax credits.

The most common reason businesses fail to take advantage of R&D tax credits is because they mistakenly believe they don't qualify. Many businesses are also under the impression that the process of obtaining these tax credits and deductions is too complex to take on alone. However, a complicated tax code should not stand between your firm and the lucrative incentives to which you are fully entitled under the law.

The 179D Deduction

Construction companies qualify for many powerful tax incentives-- incentives that can infuse cash back into your business and ensure your continued growth, strengthening your bottom line. If you are designing or renovating federal, state or local government-owned buildings, you may be eligible for significant deductions through 179D.

For instance, a construction company that works with a vast industry capacity, including clients in the commercial/retail, education, and industrial/institutional industries, took advantage of the benefit offered through section 179D and received over $2.4 million in federal tax deductions, resulting in permanent tax savings and financial statement benefit. This company's property building envelope system qualified under the fully qualifying property provision for an energy efficient property, and as a result of their utilization of the 179D deduction, the firm developed an increased cash flow and reinvested within itself and its future energy efficient design activities.

The federal Energy Efficient Commercial Building Tax Deduction, section 179D of the tax code, provides a benefit for the construction ***(or improvements)*** of a building that, in brief, surpasses 2001 ASHRAE standards. In writing the 2005 Energy Policy Act, lawmakers not only sought to encourage commercial building owners to save energy and help cut global-warming carbon gases, they also wanted to provide similar incentives for government agencies to do the same. How did Congress accomplish that? By allowing the federal, state or local government agency that owns the building to transfer the tax deduction to the design construction, engineering or architectural firm responsible for the building.

Because federal agencies, school districts, state governments, county boards, and local city and town councils do not pay federal taxes, many 179D candidate properties have been overlooked. As a result, lawmakers decided to allow these government bodies to allocate their 179D deductions to architects, engineers, contractors, and energy companies involved in energy-efficient projects.

Between 2010 and 2030, total building sector energy consumption in the United States is predicted to increase by about seven quadrillion Btu. To explain, one quadrillion Btu is the energy equivalent to 36 million tons of coal being burned at a power plant—obviously, this is not good news for our country. The Energy Policy Act of 2005 was created to ensure our energy consumption was kept under control, and the 179D deduction is an available and proactive outlet for designers.

Qualifying for 179D

There are four key aspects to consider when acquiring tax savings through the 179D deduction.

First, determine whether your company worked on qualifying government buildings. Think broadly. All federal, state, and local buildings are eligible. Examples of this can include a state university, a local airport, an army barracks, or an office building. In addition, any building that has been placed in service in the past three years or is going to be placed into service this year could qualify as well. Further, it is not only new buildings but any improvements or renovations made to those buildings may also capture this deduction.

The next determining factor—is the building energy efficient? As previously mentioned, this incentive allows for improvements over 2001 standards, and we find in practice that most states' building codes already require significant improvements over 2001 standards. It is important to keep in mind that there are a number of ways to qualify ***(and partially qualify)*** for the tax deduction since the law covers interior lighting, heating, ventilation and air conditioning ***(HVAC)***, hot water systems, or improvements to a building's envelope, the so-called "skin" of a building. You don't have to be growing grass on the roof or powering electricity with solar panels. As long as the project reduces energy consumption, it could qualify. The energy saving features which are recognized by section 179D include efficient interior lighting, efficient heating systems, efficient cooling systems, efficient ventilation systems, and efficient hot water systems, and the energy savings building envelope features include low heat transfer glass, shading, insulation, and heat storage construction.

Perhaps one of the most crucial and urgent aspects of acquiring tax deductions through section 179D is the allocation letter. The IRS requires that the construction firm receive a signed letter that assigns the tax benefits from the government. This letter has all sorts of bells and whistles that are required, and while this task may seem simple upon first inspection, securing this signature is much harder than you'd think. Luckily, we have a whole team assigned to getting the necessary letters signed and have had great success in doing so, but it certainly takes time and effort. It is also a race against time because the three year look-back period is expiring and others involved in the design of the building may seek the same letter and tax benefits for the same project. Delay can cost, so be sure to seek out the expertise of a specialty tax firm that is familiar with the specifics of the R&D tax credit to help you be the first to claim this letter.

Finally, the law requires that there be an independent determination of the energy efficiency ***(and therefore the amount of tax benefits)*** for a building. This must be done by an independent engineering firm. To ensure that the construction company receives the maximum benefits available, it is vital to have engineers who understand the tax implications of 179D, as well as accountants and tax lawyers who are familiar with the engineering sector. We have often seen architects and engineers leave money on the table because there is not the necessary expertise assisting them.

The Future of 179D

The future of Section 179D, along with several other energy provisions, expires at the end of this year, but this no reason for alarm because the future looks bright. Architects are responsible for over 18 percent of the United States' GDP and 20 percent of all American jobs and we are very pleased to be partnering with the American Institute of Architects ***(AIA)*** to help convey the needs of architects and designers. The American Institute of Architects ***(AIA)*** and the American Council of Engineering Companies ***(ACEC)*** is also pulling the oars on keeping 179D on the books. The administration has been supportive of continuing – and expanding – Section 179D ***(looking to increase the benefit to up to $3.00 per square foot)***. Bipartisan legislation and the Commercial Building Modernization Act ***(that would have kept 179D in place and expanded the benefits to $3.00 per square foot),*** was introduced in the Senate during the last Congress.

The quantification and detailing of the value, and of course, the proper substantiation for capturing the deduction requires a deep understanding of the Tax Code, the intent of the law, and an equally deep understanding of the industry being served. For these reasons, seek the counsel of a specialty tax services firm to ensure your business claims the deductions they are entitled to before time runs out. The time for construction companies to act on this valuable incentive is now!

Don't let the door close on the financial stability offered through the R&D tax credit and 179D deduction. Utilize these incentives to drive your company and U.S. innovation forward and ensure that your doors stay open!

Dean Zerbe is the National Managing Director for alliantgroup and former Senior Tax Counsel for the U.S. Senate Finance Committee. Dean is responsible for monitoring and influencing tax-related, legislative activity in Washington, D.C., on behalf of our industry clients and CPAs. During his tenure as a Senate senior staffer, Dean was intimately involved with nearly every major piece of tax legislation that was signed into law.

Linda McCluskey is the Managing Director of Energy Credits and Incentives for alliantgroup as well as a member of AIA and The Green Building Council. She is also a published author of numerous articles and a sought after speaker on topics relating to energy incentives. Linda is instrumental in helping hundreds of architecture, engineering, and contracting firms claim valuable energy deductions that help them remain competitive.