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Final IRS regulations address capitalization vs. expensing

Over the years, many contractors have struggled to determine whether they're allowed to immediately deduct a given business expense, or whether they must capitalize it over a period of years. This past fall, the IRS released its long-awaited final regulations on the tax treatment of expenditures related to tangible property — so contractors and other business owners finally have some answers to the "deduct or capitalize" quandary.

Visiting the safe harbors

Under the new regulations, an "improvement" to a building structure or to any of its distinctive building systems (for example, plumbing or electrical) must be capitalized. An improvement takes place when there's a betterment, restoration or adaptation of a unit of property. There are, however, a couple of safe harbors to the capitalization requirement that differ from previous regulations.

A notable safe harbor introduced by the new regulations applies only to qualified small business taxpayers.

First, under the routine maintenance safe harbor, an activity isn't an improvement (and may, therefore, be deductible) if the taxpayer expected to perform it as a result of use of the property or to keep the property operating normally. Routine activities are generally those that, when the property was placed in service, the taxpayer reasonably expected to perform more than once over the property's life.

The final regulations extend the routine maintenance safe harbor to buildings. But a taxpayer must

reasonably expect to perform the building-related activities more than once in 10 years. (Note: The regulations make other notable revisions to this safe harbor, and not every activity that falls outside the safe harbor may need to be capitalized.)

The second notable safe harbor introduced by the new regulations applies only to qualified small business taxpayers (generally, those with gross receipts of $10 million or less). For buildings that initially cost $1 million or less, these taxpayers may elect to deduct the lesser of $10,000 or 2% of the adjusted basis of the property for repairs, maintenance, improvements and similar activity each year.

Taking the tests

The final regulations update a couple of tests used to determine whether an expense should be capitalized. Under the *betterment* test, expenditures no longer "result in" a betterment. Instead, capitalization is required for expenses invested to materially increase the productivity, efficiency, strength, quality or output of a unit of property, or that are a material addition to a unit of property.

For the *restoration* test, a new definition has been applied to determining whether an amount spent on replacement constitutes a restoration (and, therefore, must be capitalized). The definition stipulates that a replacement of a major building component or system, or a large portion of the physical structure of the building or one of its systems, will constitute restoration and require capitalization of that expense.

Expensing by the rule

Under the so-called "de minimis rule," the previous temporary regulations established an aggregate ceiling, based on a company's financial statements, limiting the amounts the taxpayer was allowed to expense. The ceiling was the greater of 0.1% of the gross receipts for the tax year for income tax purposes, or 2% of the total depreciation and amortization expense for the tax year.

The final regulations replace this ceiling with a new safe harbor determined at the invoice or item level. A taxpayer with the proper written accounting procedures and an applicable financial statement (generally an audited financial statement or one required to be submitted to a federal or state government or agency) now can apply the de minimis rule to deduct all properly expensed amounts up to $5,000 per invoice or per item. (Taxpayers without applicable financial statements may expense amounts under a separate de minimis rule.)

The new regulations clarify that conforming to the de minimis rule is an *irrevocable* but *elective* safe harbor. If you do elect to expense under the new, invoice-based rule, you must apply it to all amounts paid in the taxable year for tangible property that meets the requirements — including amounts paid for *all* materials and supplies. Previous regulations allowed taxpayers to choose which materials and supplies they wanted to expense under the rule.

Determining your situation

The final regulations generally apply to tax years beginning on or after Jan. 1, 2014. So this year may bring great change to how your construction company handles the tax treatment of tangible property you lease or own — including buildings, machinery, vehicles, furniture and equipment.

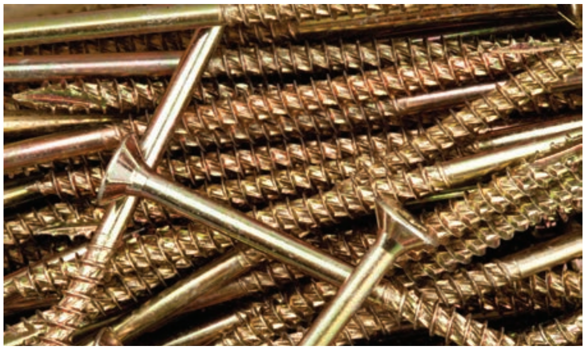
Work closely with your tax advisor to review the new rules and determine how they might affect your particular situation. The revised regulations may also greatly affect your existing customers or prospective ones. ☒

Key changes to rules covering materials and supplies

Many construction companies keep materials and supplies on hand and consequently wrestle with whether these items may be capitalized or expensed. The final regulations (see main article) largely conform to the previous temporary regulations — with a few key changes.

The dollar threshold for property that's exempt from capitalization has risen from $100 to $200. You may still elect to capitalize certain materials and supplies, but you're now limited to only rotable (regularly maintained), temporary or standby emergency spare parts. (You can revoke this election by filing a ruling request.)

Also, the previous temporary regulations stipulated that taxpayers must treat all rotable and temporary spare parts as either used or consumed in the year of disposition *or* elect to treat them as depreciable assets. You may now separate these items into pools and choose whichever treatment best suits your needs.



Bonding outlook: A familiar scene in 2014

There it is before you, construction company owners: a new year. With all of those months ahead, now is a great time to assess your bonding capacity and get a good read on the surety market ahead.

If you're expecting surprises, stop right there. Generally, when it comes to bonding, contractors should anticipate a pretty familiar scene in 2014.

More of the same

As you know, bonding assures owners that you'll complete projects as well as compensate first-tier subcontractors, workers and suppliers. Weak bonding capacity severely limits the size and number of jobs you can accept.

Recently, the bonding scene hasn't been quite as bleak as it was following the 2008 recession. Sureties have, by and large, been willing to see the positives in the construction industry along with the negatives. This likely won't change.

Over the past year, residential spending has generally risen and unemployment rates have moderated for the better. So the five major sureties who handle about half of the market share will probably stick to the processes and underwriting standards you've been experiencing recently, with smaller bonding providers likely falling in line behind them.

Sureties have, by and large, been willing to see the positives in the construction industry along with the negatives.

As always, though, startup construction companies could have a tougher time. Newly independent contractors may rely on previous experience to establish an equity position. Unfortunately, a history of bringing in profitable contracts for another company doesn't translate into accumulated earnings for the new business. And underwriters look for equity on your balance sheet to verify that you have enough cash to cover loss jobs before they have to bail you out.

Capital concerns

To keep your construction company's surety limits right where they are, or even potentially increase them, continue to work closely with your financial advisor as well as bonding and insurance agents. They can help you find ways to increase your working capital.

To maximize bonding capacity, your financial statements must show substantial working capital (current assets minus current liabilities). Ways to raise this critical amount include:

- Moving equipment held for resale up to current assets,
- Pushing your credit line's maturity date back one year and a month, and
- Extending debt to longer terms (even if you pay it down earlier).

All of these methods can increase the starting point from which sureties will calculate your bonding capacity.

Yet your bottom line alone needn't necessarily determine your bonding capacity. Substantial letters of credit, concrete personal guarantees and more expansive financial statements can also help qualify you. In addition, upgrading your compiled financial statements to a review, or from a review to an audit, can give an insurer the "warm fuzzy" it needs.

Relationships matter

A strong relationship with a surety can take years to build. If you've achieved that and believe you have a bonding provider that understands your construction company and is easy to communicate with, don't be in a hurry to shop around.

On the other hand, if you're getting mixed messages about underwriting standards or simply have a nagging suspicion you could get a better deal elsewhere, investigate other insurers in the marketplace.

Many publicly traded surety companies' financial statements and debt ratings, which effectively measure underwriters' relative financial positions, are available at sec.gov. (To get started, click on the "Filings" tab at the top of the home page.) You also might ask other contractors in your area which surety they use and how their relationships are going.

Results may vary

As you roll forward and dig into another calendar year, it's probably safe to expect no sudden fluctuations in the overall availability or pricing of surety bonds. What's more, assuming your company's financial results have remained relatively stable, your bonding capacity shouldn't change too much, either.

Of course, as the saying goes, individual results may vary — certain sureties could buck national trends depending on their own financial positions and the precariousness of their respective markets. Be sure you know where you stand with your bonding provider. ☒

Planting the seeds of tomorrow's skilled workforce

Has there ever *not* been a skilled labor shortage in the construction industry? For years, contractors have been reading about the lack of workers who perform the detailed tasks that can make or break a project's profitability. Unfortunately, times haven't changed.

Last fall, the Associated General Contractors of America released the results of an industry study in which 74% of respondents reported having difficulty locating qualified "craft" workers such as carpenters, equipment operators and technicians. The same percentage of respondents also stated that there simply aren't enough skilled laborers hitting the employment market to fill future demands.

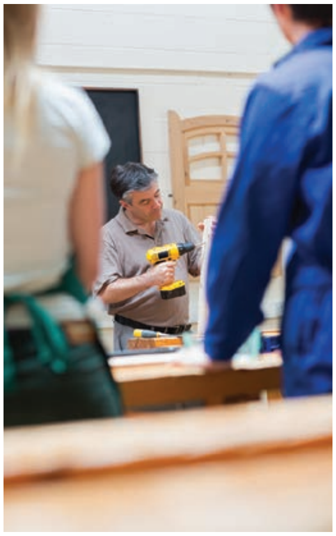
What can you do?

Although contractors can't create craft workers out of thin air, you can plant the seeds of tomorrow's skilled workforce. Here are some things you can do right now:

Participate in career or job fairs. Tomorrow's skilled labor is today's student body. High schools and community colleges are stocked with talented young minds and hands, ready to learn the construction trade. Many of these individuals either aren't aware of the opportunities in the industry or just haven't decided on a career path yet.

If every construction company offered just one mentorship, it could make a difference.

Help them by taking the time and making the relatively minimal investment of setting up booths at local and regional job or career fairs. Your objective isn't necessarily to hire everyone to whom you speak; rather, it's to point visitors to the educational programs that will turn them into skilled laborers.



Offer mentorships. You've likely heard that old saying, "If you want to get something done right, do it yourself." This is certainly the case with mentorships. By offering one, you'll be providing one or more individuals with hands-on training alongside your existing craft workers.

Mentorships are a slow and steady approach to growing the skilled labor force. But if every construction company offered just one, it could make a difference.

Set up or support a construction learning academy. Rather than training one or two craft workers at a time via a mentorship, collaborate with other area contractors and interested parties (real estate developers, government agencies) to create a construction learning academy.

Granted, this is an ambitious step that will entail a substantial investment of time, money and energy. But doing so could make a long-term difference. If one of these academies already exists in your area or region, be sure to support it.

Can technology help?

Wouldn't it be nice to just tap your smartphone or tablet a couple of times and find a skilled worker? Well, maybe you can. In September 2013, an online social network specifically designed for skilled construction labor was launched. It's called WorkHands (workhands.us) and, as of this writing, an iOS app is already available. An Android version is in the works.

Social networking can be tricky territory to navigate when trying to locate craft workers. You might find yourself spending a lot of time online with precious few results. Nonetheless, having a presence on WorkHands, as well as LinkedIn and Facebook, is important from a visibility standpoint.

What lies ahead?

The future of skilled labor really depends on the construction industry itself. Ignore the problem and it will probably get worse. But if you get involved, in a measured and cost-effective manner, you'll likely be able to ease the strain of finding qualified craft workers in the years ahead. ☒

The Contractor's Corner

What's a smart building?

I own a midsize commercial contracting company that's been in business many years. We've always tried, and mostly succeeded, in keeping up with technology. But, the other day, one of our projects hit a snag because of the complex installation of several hundred "sensors" in a new building's structural components. When I asked the owner's rep about it, she shrugged and said, "It's a smart building. These things happen." So, what's a smart building?

You've likely been working on smart buildings for years and have just never heard the term in the proper context. These structures, which are already all around us, are an important and still growing construction trend.

Data driven

Nowadays, data drives everything. Property owners are increasingly equipping their buildings with the types of sensors you encounter to gather and track information about the structure's usage and performance. With this data, owners can better regulate the "smart building's" energy consumption and, ultimately, save money.

Just last year, Pike Research issued a report on the growth of "smart city" initiatives — large-scale efforts to introduce smart buildings under a sustainable approach that also promotes well-being in the local populace and economic development. The study found that the smart city technology market will exceed $20 billion in annual value by 2020.

New and renewed

As you probably learned while working on your recent project, the name of the game with smart buildings is *integration*. Traditional building management and control systems, built and installed by construction companies such as yours, now need to converge with the technology infrastructure. Sensor-collected data then flows directly to the management and control system to automate everything from HVAC to lighting to security features.

Smart technology, however, isn't limited to new construction. You may also encounter it in renovations and rehabs. For instance, within the last two years, software giant Microsoft upgraded 118 buildings on its Redmond, Wash., campus with more than two million data-gathering sensors.

At the same time, don't assume every building will be completely automated. In the health care sector, for example, some facilities are finding that manual control of lighting and ventilation systems remains more effective because high traffic volume hampers computerized efforts to regulate energy usage.

Not going anywhere

Going forward, commercial contractors like you, as well as homebuilders, should learn about and even train for the construction of smart buildings. This will be particularly important for companies that work on design-build projects, where complex technologies are often factored into building plans upfront. Let's be honest — computers aren't going anywhere, and neither is this trend. ☒