

YEAR END TAX PLANNING ISSUES FOR ENGINEERS



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Agenda

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- What and who are you planning for?
- What is a Professional Service Firm?
- Entity Selection and Considerations
- Method of Accounting for Tax Purposes
 - ▣ Accrual
 - ▣ Cash
 - ▣ Hybrid
- Deferred Cash Deductions
- Other Risk Areas
- Tax Credits
- Year End Payroll Considerations



Decision Making Process

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- Consider all the constituents in the process
 - Shareholders
 - Tax Strategy
 - Financial Reporting Goals
 - Bank and financial covenants
 - Effect on overhead rates
 - 2009 and Long-Term Goals
 - Employees and Future Owners

- A current tax savings strategy may be a great idea in isolation, but not when considering other long-term tax strategies or how it may affect the financial statements

- When making any decision consider if the strategy is aligned with the firm goals.



What is a Professional Service Firm?

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- Are you a Professional Service Firm?

- Business definition

- Tax definition
 - Qualified Personal Service Corporation (PSC) - 2 Factor test
 - 95% ownership by professional who perform services

 - 95% of revenues generated from professional services

 - This is important in choosing entity type as well as method of accounting



Entity Selection and Considerations

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- C Corporation
 - ▣ If a qualified PSC or a P.C., then flat tax rate of 35% for federal
 - ▣ Second level of tax upon sale on built in gains

- S Corporation
 - ▣ Certain types of owners prohibited
 - ▣ Profits and losses tax at individual level and allocate prorata based on ownership
 - ▣ Generally no second level of tax upon sale

- Limited Liability Company
 - ▣ Tax reflective of the members individual tax rates if partnership form selected
 - ▣ More flexibility in terms of allocation of profits and losses



Entity Selection and Considerations

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- Are you operating in the best form of ownership in relation to goals?
- Can you switch forms of entity?
- What are the costs and benefits?
 - If there are no prohibited owners, then what are the costs and do they outweigh the benefits?
 - Some “costs” to consider are as follows:
 - Net operating losses in the C corporation that have not been utilized
 - Potential tax due on built in gains (cash vs. accrual basis) if you wanted to move to a LLC partnership forms
 - Individual taxes can be more complicated
 - Some benefits to consider:
 - Significant differences in tax upon sale
 - Flexibility offered by flow through entities
 - S corporation flow through not subject to self-employment tax
 - Admitting new owners may be easier in a partnership form



Method of Accounting for Tax Purposes

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- Accrual Basis Method of Accounting
 - ▣ Revenue is recognized when “earned”
 - ▣ Expenses are recognized when “incurred”
 - ▣ Matching concept
 - ▣ This is the preferred financial reporting method of accounting

- Cash Basis Method of Accounting
 - ▣ Revenue is recognized primarily when received
 - ▣ Expenses are recognized primarily when paid



Change in Accounting Method

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- Switching from one method to another
 - ▣ Form 3115 must be filed
 - ▣ Spread over 4 years available under certain circumstances



Accrual Basis Method of Accounting

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- Matching concept means that you need to accrue the expenses incurred in generating the revenue that you are recognizing
- This is a required method of accounting for tax purposes of many business who are large and or have inventory
- Is it necessary for your Company?



Accrual Basis - Tax Opportunities

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- Recurring/prepaid items election
- Pension plan deduction
- Year end bonuses
- Alternative methods of depreciation



Accrual Basis - Prepaid Item Election

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- ❑ You may be able to deduct certain expenses on a cash basis even though the Company is an Accrual Basis tax filer.
- ❑ Biggest opportunity for tax deferral is related to insurance
- ❑ Services and rent are excluded
- ❑ Can represent a significant tax deferral in the first year
- ❑ Subsequent year, the adjustment (increase or decrease to taxable income) represents a change from the prior year calculation
- ❑ If you can benefit from this, you may be eligible for an automatic change or may have to have the change applied for and approved



Accrual Basis - Prepaid Item Election

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- Prepaid items election for liability insurance
- Example:
 - First year tax deferral

An accrual method taxpayer with a 12/31/09 year end has an insurance policy that begins 12/1/09 for \$12,000. If payment is made prior to the filing of the tax return the entire payment can be deductible.

- Subsequent year tax deferral

In the above example, if the policy increases to \$15,000, an additional \$3,000 benefit will occur (\$15,000-\$12,000).



Accrual Basis – Employee Benefits

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- Bonuses if paid for within 2 ½ months after year end
 - ▣ For a 12/31 year end, this date would be 3/15 of subsequent year
 - ▣ Be careful about how the new 409(a) deferred compensation rules may affect the deductibility

- Employer contributions to a pension plan if paid for by the extended due date of the tax return
 - ▣ For a 12/31 year end corporation, this date would be 9/15 of subsequent year if the return was extended
 - ▣ For a 12/31 year end partnership, this date would be 10/15 of the subsequent year if the return was extended through that date
 - ▣ Be careful to review you pension plan document to make sure your plan does not say you need to fund the employer contribution earlier



Cash Basis Method of Accounting

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- Cash vs. Accrual decision
- If you are eligible, this could represent a significant deferral (not permanent savings) of taxes
 - ▣ Time is money
 - ▣ Consider how this accounting method fits into the Company's goals
- Many firms think they are too big to report on the cash basis of accounting
 - ▣ Are you a Professional Service Corporation? Go back to the 2 factor test.
- If you are a PSC, you are never too big for cash tax reporting
 - ▣ Consider applying for a change in methods – Form 3115
 - ▣ Needs to be done prior to year end
 - ▣ May be automatic if your revenues are under \$10,000,000
 - ▣ Filing fee required
- Most PSCs that are C Corporations already file on cash method of accounting, but double-check



Cash Basis - Tax Opportunities

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- Prepayment of expenses
- Deferral of invoicing and collections
- Pension plan deduction
- Consider goals of the company first
- Align the tax strategies with goals



Cash Basis - Prepayment of Expenses

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- Consider how this will affect Q1 of 2010
- Start by considering prepaying expenses that you would normally incur in Q1 of 2010
- Ordinary and necessary
- Examples:
 - Rent
 - Check with landlord, negotiate a discount
 - Insurance
 - Make sure if contract is ending you intend to renew with that vendor
 - Leases
 - Under which you have current obligations
 - Payroll that is going to get paid on January 1st or 2nd
 - Be careful doing this as you do not want to affect others individual tax planning
 - Purchase that fixed asset project if you can utilize more Section 179 depreciation. Purchases can be financed or charged.
 - Give the software company or other consultant a prepayment on Q1 maintenance contract or professional services



Cash Basis – Prepayment of Expenses

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Prepayment of Expenses (Cash Basis)

- Capitalization
- “12 Month Rule”
 - A tax payer is not required to capitalize costs for any right or benefit that does not extend beyond the earlier of (1) 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 December 1, 2009 through November 30, 2010. If the taxpayer pays the full premium on December 1, 2009 he may deduct the full premium in 2009, even though most of the benefit covers the 2010 year. However, the taxpayer could not deduct a payment in 2009 for more than one year, nor could he deduct in 2009 a payment for the one year period running from February 2010 through January 2011, unless he requests a change in accounting method.
 - The (12 month) rule means that taxpayers are not required to capitalize cost that qualify – but if capitalization is desired, it is still available.



Cash Basis – Deferral of Invoicing/ Collections

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- If you defer the cash collected, then it will not be taxable income
- You may have to defer invoicing so collections are deferred properly
- Watch out for “constructive receipt” problem
 - If you collect cash and just do not deposit it, it is still considered cash received on the cash basis



Cash Basis – Pension Plan Deduction

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- Employer contributions to a pension plan if paid for by the extended due date of the tax return
 - For a 12/31 year end corporation, this date would be 9/15 of subsequent year if the return was extended
 - For a 12/31 year end partnership, this date would be 10/15 of the subsequent year if the return was extended through that date
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Savings and Traps in the New Tax Law

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□ Tax Savings Strategies

- Production Deduction: 6% (2009) and 9% (2010 and after) deduction for A/E/C firms because they work on construction projects.

- Calculation:

A C Corporation had a \$1 million net income for 2005, all of their activities related to construction work and they had W-2 wages of at least \$60,000. The corporation would be entitled to a \$30,000 deduction, and at a tax rate of 35%, a reduction in federal tax of \$10,500.

If in the above example, the corporation was an S corporation with one shareholder, the shareholder would receive the \$30,000 deduction. If the shareholder was in the 35% tax bracket, his personal federal income tax would be reduced by \$10,500.



Deferred Cash Deductions

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- Profit Sharing Plan
 - Employer contribution is a way to defer tax and give an incentive to employees
 - Employee contributions
 - Employer Contributions
 - 401(k) matching
 - Additional discretionary contribution
 - Possible required contribution if “Top Heavy”
 - Know your plan

- Depreciation
 - Bonus depreciation is available through 12-31-09
 - Generous Section 179 deduction is still in place
 - Section 179 2009 limit - \$250,000

- Credit card bills are deductible and considered “cash” even when unpaid



Other Risk Areas and Opportunities

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- Non-Deductible Expenses
 - ▣ Country club dues
 - ▣ Sky box license fees
 - ▣ Sports tickets in excess of fair value
 - ▣ Penalties
 - ▣ Syndication costs
 - ▣ Political contributions
 - ▣ Personal expenses
 - ▣ or Shareholder fringe benefits
 - ▣ Officers' life insurance



Other Risk Areas and Opportunities

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- Accountable plans
 - Compensation vs. reimbursement (accountable plan)
- Meals & entertainment
 - Tax documentation
 - Exceptions to 50% rule
 - Extravagant – non-deductible
 - Company wide events – 100% deductible
- Multi-state allocations
- Sales tax deficiencies
- Related party transactions
- Reasonable compensation
- Various tax credits and financing credits available



Meals and Entertainment

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- Meals & entertainment
 - Tax documentation
 - Exceptions to 50% rule
 - Expenses treated as compensation
 - Reimbursed expenses
 - Recreational expenses for employees
 - Items available to the public
 - Entertainment sold to customers
 - Expenses includible in income of persons who are not employees.
 - Extravagant – non-deductible
 - Company wide events – 100% deductible



Tax Credits/Deductions & Incentives

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Tax credits / deductions and financing incentives

- State – Tax Incentive Financing (“TIF”)
- Economic Opportunity Area Credit (“EOAC”)
- Abandoned property deduction
- Employee training grants
- Historic federal & state renovation credits (20%)
- Federal – renovation credit (10%)
- Employment credits (WOC, Empowerment Zone)



Year End Payroll Considerations

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- ❑ Personal use of auto
- ❑ Group term life insurance
- ❑ Officer's life and disability
- ❑ Form W-4
- ❑ Independent contractor reporting
- ❑ Pension distribution
- ❑ Electronic Federal Tax Payment System



Year End Payroll Considerations

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Limits Table	2009
Elective Deferrals	\$16,500
Catch-up contribution	\$55k
Def Ben \$ Max	\$195k
DCP Annual Additions	\$49k
Compensation Limit	\$245k
Highly Comp EE Limit	\$110k



ANY QUESTIONS?



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