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Tax Planning Strategies for A/E Firms

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*“The hardest thing in the world to understand is
the income tax.”*

~ Albert Einstein

... Webinar Agenda

- Discuss the overall tax planning process for A/E firms
- Discuss business tax provisions impacting A/E firms
- Discuss business tax credits and deductions impacting A/E firms
- Discuss additional tax planning considerations for A/E firms and their owners for 2024

The Overall Tax Planning Process for A/E Firms

••• The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

- The first step in the tax planning process for A/E firms should be making sure that the entity is using the appropriate method of accounting for income tax purposes to minimize their tax liabilities
- Internal Revenue Code (IRC) Section 448(b)(2) allows “qualified personal service corporations” to use the cash method of accounting in determining taxable income regardless of their level of gross receipts
- The cash method of accounting is favorable over the accrual method of accounting as firms can defer the income recognition on billed receivables and work-in-process until such amounts are ultimately collected from clients

••• The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

- To meet the requirements of a qualified personal service corporation, a firm must meet both the function test and ownership test
- Under the function test, substantially all (95% or more) of the time spent by employees must be devoted to the performance of services in the fields of health (including veterinarians), law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts or consulting
- Under the ownership test, substantially all of the value of the corporation's stock (95% or more) must be held (directly or indirectly) at all times during the tax year by current or retired employees who performed the services or by their estates or beneficiaries (but only for a two-year period)

The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

- Qualification as a personal service corporation is not always clear. It is important to review on an annual basis and with relevant case law.
- In Alron Engineering & Testing Corp., the firm provided both geotechnical testing (20%) and customary engineering services (80%) and the Tax Court held that the provision of geotechnical testing services was not within the field of engineering, nor was it “incident to” engineering
 - Even though the firm was 100 percent owned by a full-time engineer, it was held that it did not meet the statutory definition of a personal service corporation.
- In a similar Tax Court case, Grutman-Mazler Engineering, the court found that the planning department activities, which included submitting designs, plans, tentative tract maps, grading plans and other engineering reports, fell within the applicable state law’s definition of civil engineering and that the firm was a qualified personal service corporation

••• The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

- Other cases illustrate that individuals engaged in the specified professional activities do not need to be licensed in that particular field to qualify
- In Kraatz & Craig Surveying, none of the corporation's employees were licensed engineers; however, surveying services performed by the land surveying corporation were considered services performed within the field of engineering even though it did not perform any services required to be performed by licensed engineers under state law
 - The Tax Court found the corporation was a personal service corporation, stating that surveying was traditionally regarded within the field of engineering
 - The Tax Court stated the issue was to be decided by facts and circumstances instead of by state licensing laws

••• The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

- Partnerships/LLCs/LLPs who do not have a C corporation as a partner are permitted to use the cash method of accounting by definition under Section 448(a) and are not subject to the personal service corporation rules applicable to C corporations
- S corporations that are exclusively engaged in a service business, not otherwise required to maintain inventory and are not a tax shelter may utilize the cash method of accounting for tax purposes

••• The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

- Use of the cash method of accounting is beneficial to A/E firms since they will not pay individual tax or corporate-level tax on accounts receivable or unbilled work-in-process until the cash is collected
- The result of this is a deferral of tax equal to the dollar value of accounts receivable and unbilled work-in-process over that of a firm's accrued expenses and accounts payable
- Even if using the cash method of accounting for income tax purposes, it is still important for A/E firms to maintain the accrual method of accounting for internal and financial reporting purposes, as well as to properly manage for profitability

The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

	12/31/2024 Balance	Income Tax Deferral
Current assets:		
Cash & equivalents	\$ 70,202	\$ -
Accounts receivable	2,785,444	2,785,444
Work-in-process	525,689	525,689
Prepaid expenses	64,536	64,536
Total current assets	<u>3,445,871</u>	
Fixed assets:		
Property & equipment	1,579,666	-
Accumulated depreciation	(1,052,689)	-
Net fixed assets	<u>526,977</u>	
Other assets:		
Cash value of life insurance	279,865	-
Other assets	6,895	-
Total other assets	<u>286,760</u>	
Total assets	<u>\$ 4,259,608</u>	
Current liabilities:		
Accounts payable	\$ 1,456,987	(1,456,987)
Accrued payroll & other liabilities	199,548	(199,548)
Billings in excess of costs	502,356	(502,356)
Current portion of long-term debt	112,564	-
Total current liabilities	<u>2,271,455</u>	
Long-term liabilities:		
Long-term debt	172,658	-
Total liabilities	<u>172,658</u>	
Stockholders' equity:		
Common stock	1,000	-
Additional paid-in-capital	50,000	-
Retained earnings	1,764,495	-
Total stockholders' equity	<u>1,815,495</u>	
Total liabilities and equity	<u>\$ 4,259,608</u>	<u>\$ 1,216,778</u>

Total deferred income for tax reporting purposes under the cash method of accounting

••• The Overall Tax Planning Process for A/E Firms Cash Method of Accounting

- If a firm qualifies to use the cash method of accounting but is still using the accrual method of accounting for tax reporting purposes, a request for change in accounting method can be made by filing Form 3115, Application for Change in Accounting Method, up until the due date of the return for the current year, including extensions
- Firms that want to utilize the cash method of accounting should contact their tax professional to assist with the change

... The Overall Tax Planning Process for A/E Firms

- Since most A/E firms should be utilizing the cash method of accounting for tax reporting purposes, tax planning is important for the decision-making process regarding the most effective utilization of the firm's cash to not only minimize tax on the part of the firm and its owners but also to carry out the firm's strategic objectives and goals
- Certain decisions will have to be made by the firm's owners regarding discretionary expenses, paying existing expenses, capital spending, and potentially prepaying expenses for the following year
- In addition, an essential part of the process involves utilizing the federal and state income tax benefits available to A/E firms and their shareholders such as accelerated depreciation, the Research & Development tax credit, the Section 179D tax deduction, the Qualified Business Income (QBI) deduction, and other tax benefits
- An A/E firm's form of entity (C corporation/S corporation/LLC/LLP) also plays an important role on how the tax planning process is carried out and how these decisions are made



The Overall Tax Planning Process for A/E Firms: C Corporations

- For C corporations, the goal is to utilize tax benefits in order for the firm to shelter as much cash basis taxable income as possible without the imposition of the flat 21% corporate tax rate
- The 21% corporate tax subjects A/E firms to double-taxation – once at the corporate level and then again at the individual level when the income is distributed to shareholders in the form of compensation
- Therefore, it is important for A/E firms that are C corporations to follow the suggested tax planning process carefully to have \$0 tax as of the end of the year, which does not necessarily have to mean \$0 taxable income

••• The Overall Tax Planning Process for A/E Firms: S Corporations

- Sometimes, S corporations approach year-end tax planning in the same manner as C corporations, which produces little to no benefit to the S corporation structure
- Benefits of S corporation structure include the potential payroll tax savings of S corporation distribution vs. salary compensation; the build-up of S corporation shareholder basis over time to reduce future capital gains; and the pass-through of tax benefits to reduce overall tax burden
- For S corporations, the goal is not to yield corporate-level taxable income of \$0 since S corporation shareholders will pay tax on the firm's income whether or not it is distributed to them

••• The Overall Tax Planning Process for A/E Firms: Partnerships/LLCs/LLPs

- Partnerships, LLCs and LLPs often employ a similar tax planning process as S corporations due to their pass-through nature
- The main difference is the “self-employment tax” liability that results to a partner or member which is imposed on guaranteed payments in addition to the partner’s/member’s share of distributive net income from the entity
- Because of this, partnerships/LLCs/LLPs often approach year-end tax planning to minimize the self-employment tax by minimizing cash basis net income while passing through certain tax benefits to partners/members as a means for reducing their income tax liabilities

Business Tax Provisions Impacting A/E Firms

Business Tax Provisions Impacting A/E Firms – Section 179 Limitation Increased

- Pursuant to IRC Section 179, A/E firms are allowed to write-off the cost of qualifying fixed asset purchases up to a statutory limit
- For the 2023 tax year, the first \$1,160,000 of qualifying additions could be written off in the first year provided that the qualifying purchases during the year did not exceed \$2,890,000
- For the 2024 tax year, these limits are increased to allow the first \$1,220,000 of qualifying additions to be written off in the first year provided that the qualifying purchases do not exceed \$3,050,000
- The maximum Section 179 deduction for sport utility vehicles placed in service for 2024 is \$30,500 (up from \$28,900 in 2023)

Business Tax Provisions Impacting A/E Firms – Section 179

Taxable Income Limitation

- In addition to the dollar limitation and the investment limitation (\$1,220,000 and \$3,050,000 for 2024) the Section 179 deduction is further limited by taxable income derived from the active business during the tax year
- The limitation is calculated based on taxable income before the Section 179 deduction, net operating loss (NOL) carryback or carryforward, and deductions suspended under any section of the Code
- For C corporations, the Section 179 deduction cannot reduce taxable income below \$0 in a given year
- For S corporations, taxable income for purposes of the Section 179 limitation is computed without regard to compensation paid to the S corporation's shareholder-employees
- Any excess Section 179 costs can be carried forward an unlimited number of years subject annually to the taxable income limitation

Business Tax Provisions Impacting A/E Firms – Section 179 Qualifying Property

- Eligible Section 179 property means tangible property that is Section 1245 property, off-the-shelf computer software, and at the taxpayer's election, qualified real property
- Examples of tangible personal property include equipment, machinery, property contained in or attached to buildings other than structural components, and livestock
- The property must be acquired by purchase from an unrelated party for use in an active trade or business, and used more than 50% in an active business (i.e., other than investment use)
- For Section 179 purposes, qualified real property includes:
 - Qualified improvement property (QIP) described in IRC Section 168(e)(6)
 - Improvements to nonresidential real property, if the improvement is a roof, HVAC, a fire protection and alarm system, or a security system

Business Tax Provisions Impacting A/E Firms – Bonus Depreciation Rates

- In addition to the Section 179 expensing election, A/E firms can also utilize Section 168(k) bonus depreciation on qualifying fixed assets
- For the 2023 tax year, A/E firms may write-off the first 80% of qualifying additions, without limitation
- For the 2024 tax year, bonus depreciation rates will phase down to 60%
- Bonus depreciation rates will continue to phase down to 40% in 2025, and to 20% in 2026

Business Tax Provisions Impacting A/E Firms – Bonus Depreciation Qualifying Property

- Eligible Section 168(k) property is depreciable property with a MACRS recovery period of 20 years or less
- Most real estate fails to meet this definition; however, some real property (such as land improvements) has a recovery period of 20 years or less and is eligible for bonus depreciation
- Other examples of eligible bonus depreciation property include:
 - Qualified leasehold improvement
 - Qualified improvement property
 - Depreciable computer software that is not amortizable over 15 years under IRC Section 197

Business Tax Provisions Impacting A/E Firms – R&D Expenditures

- Prior to 2022, businesses could fully expense research and development (R&D) expenditures
- The Tax Cuts and Jobs Act (TCJA) changed how businesses are able to write off R&D expenditures effective for tax years beginning after 12/31/2021
- Amortize domestic expenses over 5 years
- Amortize foreign expenses over 15 year
- Includes software development expenditures

Business Tax Provisions Impacting A/E Firms – R&D Expenditures

- R&D expenditures required to be capitalized under current law – example:
 - Labor costs
 - Materials and supplies costs
 - Cost recovery allowances
 - Patent costs
 - Certain operation and management costs
 - Travel costs

Business Tax Provisions Impacting A/E Firms – R&D Expenditures

- R&D expenditures not required to be capitalized under current law – example:
 - Interest expense
 - Website content and hosting costs
 - SG&A service departments (payroll personnel, human resources personnel, accounting personnel)

Business Tax Provisions Impacting A/E Firms – R&D Expenditures

- R&D expenditures – examples in IRS Notice 2023-63:
 - \$100,000 of R&D costs, incurred evenly throughout the year
 - Year 1 amortization - \$10,000
 - Deferred deduction = $\$90,000 \times 30\% \text{ tax rate} = \$27,000$

Business Tax Provisions Impacting A/E Firms – R&D Expenditures

- There was hope that Congress would pass a bill to address the treatment of R&D expenditures
- The Tax Relief for American Families and Workers Act (H.R.7024) contained a provision to temporarily allow for the retroactive repeal of Section 174 SREs
- On August 1, 2024, the Senate voted against the legislation
- Since the bill did not pass, taxpayers are still required to capitalize and amortize SREs

Business Tax Credits and Deductions Impacting A/E Firms

Business Tax Credits and Deductions Impacting A/E Firms – R&D Tax Credit

- The research and development tax credit is a Federal tax incentive that is supposed to encourage businesses to increase their spending on technological research and development (R&D) activities in the United States
- Since inception, the credit has always been incremental in design to reward increases in qualified research and development spending
- The R&D tax credit is governed by Section 41 of the IRC
- Credit is calculated on Form 6765, credit for increasing research activities

Business Tax Credits and Deductions Impacting A/E Firms – R&D Tax Credit

In order for an activity to constitute “qualified research” it must meet the following four criteria:

The Section 174 test: The activity must qualify as research pursuant to IRC Section 174

The technological in nature test: research has been undertaken for the purposes of discovering information that is technological in nature

The business component test: the research is intended to be useful in the development of a new or improved business component of the taxpayer

The process of experimentation test: substantially all of the research activities are part of a process of experimentation that relates to a qualified purpose

Business Tax Credits and Deductions Impacting A/E Firms – R&D Tax Credit

- The two methods of calculating the credit are the Regular Credit Method and the Alternative Simplified Credit Method
- The credit percentage under the Regular Credit Method is 20%, however, the 20% credit rate is reduced if the taxpayer makes an election under 280C in lieu of adding back the amount of the credit into taxable income
- The credit percentage under the Alternative Simplified Credit Method is 14%
- The ASC has proven popular among taxpayers due to simplicity

Business Tax Credits and Deductions Impacting A/E Firms – R&D Tax Credit

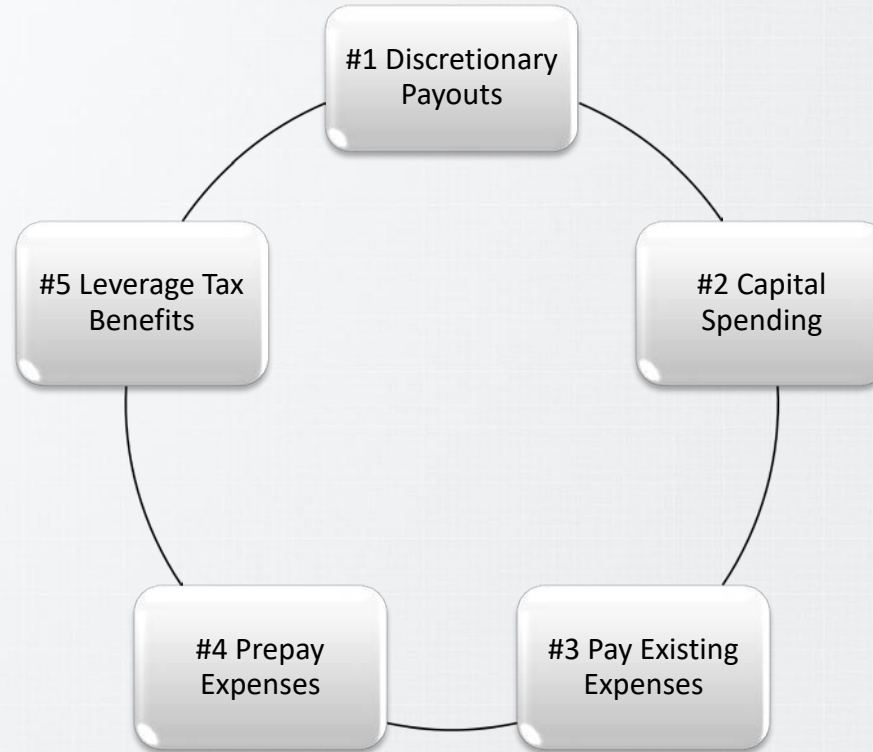
- For A/E firms taxed as C corporations, the Federal R&D credit is a component of the General Business Credit on Form 3800
- The General Business Credit is nonrefundable (can only be used to offset pre-credit tax liability), but can be carried forward
- For A/E firms structured as S corporations, partnerships, LLCs, LLPs and sole proprietorships, the utilization of the R&D credit is determined at the individual level
- Any unused credit at the individual level can also be carried forward for future use

Business Tax Credits and Deductions Impacting A/E Firms – Other Deductions Available for Consideration

- Qualified Business Income (QBI) deduction
- Pass-Through Entity Tax (PTET)
- Section 179D Energy Efficient Commercial Buildings Deduction

Additional Tax Planning Considerations for A/E Firms and Their Owners for 2024

Additional Tax Planning Considerations for A/E Firms and Their Owners for 2024



Additional Tax Planning Considerations for A/E Firms and Their Owners for 2024 – Discretionary Payouts

- Discretionary payouts are payments that the employer has the sole discretion to make, depending on the profitability and cash flow of a firm in a given year
- Examples of discretionary payouts to consider during year-end tax planning are:
 - Employee bonuses
 - Owner bonuses
 - Retirement plan contributions
 - PTO/Vacation payouts

Additional Tax Planning Considerations for A/E Firms and Their Owners for 2024 – Capital Spending

- Capital spending includes money a firm spends to buy or maintain fixed assets
- Examples of capital spending to consider during year-end tax planning are:
 - Computers
 - Software
 - Office needs
 - Vehicles

Additional Tax Planning Considerations for A/E Firms and Their Owners for 2024 – Pay Existing Expenses

- Firms have the ability to pay existing operating expenses before year-end to secure a tax deduction for the current year
- Examples of existing expenses to consider during year-end tax planning are:
 - Subconsultants
 - Vendors
 - Other accounts payable
 - Not bank debt or line of credit

Additional Tax Planning Considerations for A/E Firms and Their Owners for 2024 – Prepay Expenses

- Firms have the ability to prepay expenses and deduct them in 2024 as long as the right or benefit paid for does not extend beyond the earlier of 12 months from the date the prepaid is made, or the end of the taxable year following the taxable year in which the payment is made
- Examples of prepaid expenses to consider during year-end tax planning are:
 - E&O insurance
 - Service contracts
 - Other insurances
 - Real estate taxes

Additional Tax Planning Considerations for A/E Firms and Their Owners for 2024 – Leverage Tax Benefits

- It is important for firms to make sure that they are utilizing all the tax benefits available to them to reduce their income tax liability
- Examples of tax benefits to consider during year-end tax planning are:
 - Research and Development
 - Section 179/Bonus depreciation
 - Qualified Business Income (QBI) deduction
 - Other tax credits

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Questions



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