



2023 Year-End Tax Planning Guide

Architecture & Engineering and Construction Groups



As we approach the final stretch of the year, it's critical to focus on year-end tax considerations and strategize actions to best position you and your company for optimal tax treatment.

There is constant evolution in the architecture, engineering and construction (A/E/C) industries.

The change from conventional planning methods to virtual collaboration has not only revolutionized how we work today but has also redefined the making of our urban environments. This shift directly reflects a transformation in the A/E/C industries, where adaptability and innovation are essential factors for prosperity and growth.

Navigating the terrain of this ever-evolving industry requires more than just a compass; it requires some serious thinking, especially when it comes to tax strategies and planning. That's why we've put together this year-end tax guide. The guide features valuable perspectives and strategies tailored for the A/E/C communities. Equip yourself with the knowledge to make informed decisions as we continue to build towards a prosperous future.

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Accelerating Depreciation Opportunities

As the 2023 year-end nears, a part of your year-end tax planning should be to review fixed assets placed in service during 2023 to ensure you are utilizing the most favorable depreciation deduction method and, if considering additional fixed asset purchases, to acquire and place the assets in service before year-end. Most businesses can benefit from the rules accelerating the amount of fixed/capital assets that can be expensed.

Below is an overview of some of the methods available for A/E/C businesses to accelerate depreciation. There are several options and scenarios businesses need to consider when assessing which is the most beneficial for them.



ADDITIONAL FIRST-YEAR DEPRECIATION (BONUS DEPRECIATION)

Currently, any qualifying assets placed into service on or after January 1, 2023 are eligible for bonus depreciation equal to 80% of the purchase price. (For fiscal year taxpayers, qualifying assets placed in service prior to January 1, 2023 are still eligible to depreciate 100% of the purchase price). The percentage of bonus depreciation is scheduled to be further reduced to 60% in 2024 and 20% each year after until completely phased out for assets placed in service on or after January 1, 2027.

To qualify, the property must have a recovery period of 20 years or less and be depreciated using the modified accelerated cost recovery system. Typically, this can include, but is not limited to, furniture and fixtures, construction and office equipment, and qualified leasehold improvement property.

When considering bonus depreciation, businesses need to assess the state implications for their owners. Many states do not conform to federal bonus depreciation. At the state level, there is typically an addition and subsequent subtraction adjustment that reverse out the bonus depreciation enjoyed at the federal level. For taxpayers who can fully utilize federal depreciation, this usually does not present a major issue.

SECTION 179 EXPENSING

Under IRC Section 179, eligible taxpayers may elect to expense qualifying property up to certain dollar limitations. To be eligible, property must be purchased for use in a trade or business. Tangible personal property (e.g., furniture, equipment, etc.) is eligible for this deduction. For tax year 2023, the maximum deduction under Section 179 is \$1,160,000. There is a dollar-for-dollar phase-out once the amount of qualified Section 179 property placed in service exceeds \$2,890,000. For example, if a taxpayer has \$3,000,000 of qualifying property, the maximum deduction they can claim for tax year 2023 is \$1,050,000 (\$3,000,000 less the \$2,890,000 ceiling). The deduction is completely phased out if \$4,050,000 of qualifying property is placed in service during 2023.

This limitation is potentially calculated twice: once at the business level and then again at the owner level if the business is a pass-through entity (e.g., partnership or S-Corporation). In addition to the limitations discussed above, Section 179 expensing is limited to the trade or business income of an activity. Unlike bonus depreciation, it cannot create a net loss for the business. For purposes of this deduction, trade or business income is calculated before factoring in any deduction under Section 179.

Pass-through entities also need to consider their owners' base before electing to utilize Section 179. Trusts and estates are ineligible to utilize the deduction, although grantor trusts are eligible for the deduction. In addition, owners that are considered passive are not entitled to the deduction, even if the business is eligible, since the income from the activity is not deemed trade or business.

Disallowed deductions due to trade or business limitations are carried forward indefinitely and can potentially be utilized in a future tax year.

As with bonus depreciation, A/E/C businesses also need to understand the state tax implications. For example, New York follows the federal treatment of Section 179; however, New Jersey limits the deduction to \$25,000.

CONCLUSION

The above discussion highlights some of the high-level items that an A/E/C company must analyze when strategizing how to maximize their depreciation. Careful planning and analysis of future projects is critical to make sure depreciation is utilized in the most efficient manner.



State & Local Tax (SALT) Updates and Tax Planning Opportunities

The SALT world is constantly evolving to meet the needs of taxpayers while adapting to conform or decouple from the various previous federal modifications. The following is a brief review of some of the current trends in state and local taxes.



SALT PASS-THROUGH ENTITY TAXES (PTET)

As a reminder, to date, 36 states and New York City have enacted a PTET regime. As another reminder, the Tax Cuts and Jobs Act of 2017 limited an individual's federal itemized SALT deduction to \$10,000, thereby causing states to explore PTET workarounds.

The PTET allows an A/E/C business to pay state taxes and deduct them for federal income tax purposes thus reducing the taxpayer's overall federal tax liability. However, not every state's PTET regime is the same. Careful analysis and planning of owners' tax attributes, the mechanics of calculating the PTET liability and limitations for taking credit for other state taxes paid, including the PTET as well as other implications to the owners' state income tax filings, must be completed. When owners of a pass-through entity are residents of different states, the outcome of these elections can yield some odd results with some owners paying more tax while other owners pay less. While the various state PTET regimes can be great for reducing overall tax liabilities, the importance of analyzing the implications of these elections on the owners' overall income tax picture prior to making the election(s) is paramount to avoid or prevent adverse tax results.

Practice Tip: Partnerships that have both resident and non-resident partners or partners with differing profit and loss percentages should evaluate whether their partnership agreements have been updated to address special allocations of these tax deductions and corresponding credits. Without such amendments in place, partners may find that their PTET deduction paid by the entity is not equitable in relation to the amount of their partner income taxed in the PTET calculation.

TELECOMMUTING AND RESIDENCY CHANGES

Inquiries from A/E/C clients about moving out of high-tax states have increased each year since the early days of the COVID-19 pandemic, and 2023 was no different. The COVID-19 pandemic has proven that we can work remotely and has prompted many to explore and think about where they want to live and work. Moves from high-tax states such as New York, New Jersey and California certainly pose residency audit risks due to the respective state's loss of anticipated tax revenues.

Generally, in order to change residency status, taxpayers must change their domicile. Taxpayers who are attempting a domicile change should be aware that several factors are considered in the determination.

Caution: A temporary relocation will not change a taxpayer's domicile. However, statutory residency issues may be triggered due to a temporary relocation, where some states will treat taxpayers who exceed a certain in-state presence threshold, such as 183 days, and have a place of abode, as a resident in their state for tax purposes. It is therefore possible that a taxpayer can be treated as a resident of two states – one based on domicile and the other based on statutory residency. In most cases, the resident state tax credit will protect the taxpayer from double taxation of wages and other business income, but depending on the state, double taxation could apply to other types of income, such as investment income (i.e., interest, dividends and capital gains) and other intangible income.

Advanced planning is central to managing and mitigating this risk. Understanding each individual's facts, circumstances and intent are critical factors as well as researching and understanding each state's specific residency and domiciliary laws.

NEXUS

A nexus is a relationship or connection between two or more entities. In tax law, it is a relationship between a taxing authority, such as a state, and a business. A nexus must exist before a taxing authority can impose a tax on the enterprise, and it requires that there be a definitive link between the jurisdiction and the business. This concept is not new and has evolved and broadened its reach over the years. While the 2018 U.S. Supreme Court decision in *South Dakota v. Wayfair* was not about state income and/or franchise tax nexus, it was a groundbreaking decision that eliminated the physical presence requirement for state sales and use taxes. However, *Wayfair* did empower states to expand and apply this same concept (commonly referred to as economic nexus) for income/franchise taxes. What this basically means is that virtually any business activity that seeks and derives income from a customer or market in a given state may be creating nexus in that state. Where the business is actually located (the old "boots on the ground" logic) is no longer a determining factor in this analysis.

Market-based sourcing (looking to where the customer receives a service rather than where it is actually performed) continues to expand the economic nexus principles as more states move in this direction.

Anchin Observation: If you have not already done so, we recommend that you and your tax advisors perform a state nexus study given the vast changes that have taken place over the past few years. If certain tax exposures are identified, note that most states offer voluntary disclosure agreement (VDA) programs. Eligibility for such programs is generally automatic unless you had been contacted by the state prior to your application. A VDA will usually waive any penalties that may be assessed. Many states sometimes will also offer amnesty programs, which are similar to VDAs, but are open to all taxpayers (even those who were already contacted by the state).

Employees working in multiple states create payroll withholding and state tax nexus issues for the employer and employee. Failure to properly withhold and/or remit payroll taxes can come at a high price if a state imposes a penalty on the employer. If a state considers the employer's failure to do so intentional, it may have the power to impose a penalty as high as 100% of the amount not withheld. Considerations must be given to employees that have transitioned to teleworking permanently or that have relocated during the pandemic as those work arrangements are no longer deemed temporary and will most likely require a change in reporting. This, of course, assumes the employer is knowledgeable of such changes on a timely basis.

States are continuing their attempts to implement and enforce their laws to find nonresident, non-filing taxpayers. Nexus remains a crucial element of managing a business's state tax risk. With state budget shortfalls expected to continue into 2024 and beyond, taxpayers should expect to receive nexus inquiries from various state and local taxing authorities.

Practice Tip: For those A/E/C employers allowing employees to work remotely, nexus implications need to be thought out not only for income, non-income and sales taxes but also for state payroll withholding taxes and unemployment insurance. Both physical presence and economic presence must be thoroughly analyzed for all potential state taxes when undergoing a nexus study to understand and better manage risk.

Caution: Due to significant fiscal constraints as a lingering result of the pandemic, all signs point to an increase in state audit activity. State letters with an intention to audit as well as nexus questionnaires and notices should be taken seriously and should be addressed timely. We stand ready as your specialist advisor to assist you in handling such communications and to help you proactively plan.

Anchin Observation: Businesses should, if they have not already done so, communicate with their employees to obtain the necessary information to determine possible state filings.

An Update on Research & Development (R&D) Tax Credits



The availability of the Internal Revenue Code (IRC) Section 41 R&D tax credit for A/E/C companies stems from the recognition by the U.S. government of the crucial role these industries play in advancing technology and innovation within the built environment. The nature of A/E/C projects often involves significant research and development activities aimed at improving design methodologies, construction techniques, and overall project efficiency. These sectors continuously strive to enhance sustainability, safety, and functionality, driving innovation in building materials, methods, and technologies.

By making the Research and Development Tax Credit accessible to architects, engineers, and construction companies, the government aims to incentivize investment in creative and forward-thinking solutions, ultimately

fostering progress and excellence in the construction and infrastructure development fields. This tax credit serves as a catalyst for these industries to push boundaries, adopt cutting-edge technologies, and contribute to the overall advancement of the built environment.

THE CURRENT INTERPLAY BETWEEN SECTION 41 R&D CREDIT AND SECTION 174 RESEARCH AND EXPERIMENTAL (R&E) CAPITALIZATION

IRC Sections 41 and 174 both play pivotal roles in shaping the landscape of tax incentives for R&D expenses, yet they differ significantly in their scope and application. Section 41 focuses specifically on the Research and Development Tax Credit, which allows businesses to claim a credit for a percentage of qualified research expenses, including wages, supplies, and contract research expenses.

Section 174 is more expansive, encompassing a broader range of expenses related to research and experimentation, and applies irrespective of whether the taxpayer has claimed a tax credit.

For tax years beginning after December 31, 2021, the Tax Cuts and Jobs Act (TCJA) eliminated the option to deduct Section 174 R&E expenditures. Whether or not taxpayers claim a tax credit for R&D costs under Section 41, Section 174 now requires taxpayers to capitalize and amortize R&E expenditures over five tax years for U.S. spend and fifteen years for foreign expenses.

CURRENT STATUS

Currently, there are numerous lobbying efforts by industry groups and companies to revert Section 174 rules to the prior version which allowed for immediate deductibility for R&E expenditures. Some states have decoupled from the capitalization requirements. However, passing federal legislation will require bipartisan cooperation in the House of Representatives, the Senate, and the White House. While the current Section 174 capitalization rules can have a negative impact on cash flow, the overall tax benefits of the R&D tax credit remain the same. The capitalization requirement exists whether or not a tax credit is claimed.

While we can remain hopeful, at the present time, taxpayers should prepare to comply with rules set forth by the IRS in Section 174 in the absence of strong stewardship of the U.S. economy on Capitol Hill.

IRC Section 179D (Green) Deduction – 2023 Enhancements

The 179D tax deduction provides building owners a deduction for new or remodeled commercial buildings that meet specific energy-efficient qualifications. This deduction is also available to be allocated to the designers of buildings owned by government entities and non-profit organizations. Since the designers did not pay for the costs, the allocation is really a “free” deduction.

The Inflation Reduction Act of 2022 (“the Act”) allows for increased credits and/or deductions for various green energy credits, including the 179D deduction, if the owner/designer meets certain prevailing wage and apprenticeship requirements. The Act also lowers the minimum required savings in total annual energy and power cost from a 50% reduction to a 25% reduction. If the requirements are satisfied, the maximum 179D deduction is increased from \$1.88/sq. ft. to \$5.36/sq. ft. when there is a 50% reduction in energy and power costs, and \$2.68/ sq. ft. when a 25% reduction is achieved. If the prevailing wage/apprenticeship requirements are not met, the Act reduces the deduction amount range from \$.54 per sq. ft. (25% reduction) to \$1.07 per sq. ft. (50% reduction).



As a further benefit, the Act eliminates the lifetime limit to the 179D deduction. Now, the deduction can be taken every three tax years (four in some situations). Previously, if a taxpayer constructed a building and took the maximum deduction of \$1.88 per square foot, the taxpayer was unable to take additional 179D deductions for subsequent energy efficiency improvements. However, beginning in 2023, the Act now allows for additional 179D deductions for subsequent energy improvements.

On November 30, 2022, the IRS issued **Notice 2022-61** (the Notice) which provides guidance regarding the prevailing wage and apprenticeship requirements that are effective as of January 29, 2023. For projects that began construction prior to January 29th (as defined in the Notice), a company can get the enhanced 179D deduction without meeting the prevailing wage and apprenticeship requirements. However, from January 29, 2023 on, the enhanced deduction is only available if the company meets the new requirements.

PREVAILING WAGE DETERMINATIONS

The Notice indicates that the prevailing wage rate varies based on factors such as geographic area, type of construction performed and labor classifications for the construction work being done on the project. The Secretary of Labor has published wage determinations at www.sam.gov based on these factors. Taxpayers may rely on the published wage determinations to qualify for the enhanced 179D deduction. In the absence of published guidance for a particular geographic location, type of construction or labor classification, the Notice provides that a taxpayer must contact the Department of Labor and request a wage determination based on its facts and circumstances. The prevailing wage requirement applies to all individuals compensated by the taxpayer in exchange for services performed, regardless of whether or not the individual is classified as an independent contractor for other tax purposes.

APPRENTICESHIP REQUIREMENTS

A taxpayer complies with the apprenticeship requirement if a sufficient amount of labor hours are performed by qualified apprentices as a ratio to total labor hours for the project. For 2023, 12.5% of total labor hours must be performed by qualified apprentices.

The Notice provides for a Good Faith Effort Exception in which the taxpayer will be considered to have made a good faith effort in requesting qualified apprentices if the taxpayer requests qualified apprentices from a registered apprenticeship program in accordance with usual and customary business practices for registered apprenticeship programs in a particular industry.

Below are some examples of the 179D deduction that illustrate how various factors impact the amount of tax credits available.

Example 1: ABC Engineers (ABC) is engaged by the City of New York (NYC) to design a municipal building. NYC allocates the entire 179D deduction to ABC. The new building is 500,000 square feet. NYC incurs \$100 million of costs to place the building into service. ABC implements a design that achieves a 50% enhancement in energy efficiency and meets the requirements for prevailing wage and apprenticeship. ABC is entitled to a \$2,680,000 tax deduction ($500,000 \times \$5.36$) in the year in which the building is placed in service. If the project did not begin prior to January 29, 2023, and ABC does not meet the prevailing wage requirements, the deduction decreases to \$535,000 ($500,000 \times \1.07).

Example 2: The American Red Cross contracts with Smith Architects to design the construction for their 300,000-square-foot new headquarters at a cost of \$60 million. Smith devises a building plan which reduces energy usage by 25% and also meets the requirements for prevailing wage and apprenticeship. Smith will generate a \$804,000 tax deduction ($300,000 \times \2.68). If the project did not begin prior to January 29, 2023, and Smith does not meet the prevailing wage requirements, the deduction decreases to \$162,000 ($300,000 \times \0.54).

CONCLUSION

The enhanced 179D tax benefits will make 179D-compliant projects much more attractive to A/E/C businesses if they can comply with the requirements associated with the enhanced deduction.



About Anchin

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Its highly-focused industry specialization helps clients overcome challenges and achieve their financial objectives with exceptional confidence. Consistently recognized in respected “best of” lists for service, firm management and employee satisfaction, Anchin prioritizes partner-level engagement, and commitment to employee happiness. The full-service firm, with a staff of 500, including more than 65 partners, provides a wide range of assurance, financial reporting, tax and advisory services [including tax strategies and compliance; tax credits and incentives; state and local and international tax strategies, family office strategies management and succession advisory; growth, transition and exit strategies; transaction advisory; client accounting advisory services; cybersecurity and digital risk solutions; and litigation support, forensic accounting and valuation services]. Anchin has offices in New York City, Uniondale, New York, and in Boca Raton, Florida, and is an independent member of BKR International, a network of more than 160 firms with over 500 offices in over 80 countries around the world. Discover what’s possible by visiting us online at



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