

# CONTRACTOR UPDATE



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Well the Holidays are upon us, and for the majority of us that means your year-end is right around the corner. With that in mind, we will focus our attention to those items, tax and otherwise, that will affect your year-end or your businesses in 2007.

Before we get to that, we want to extend our thanks to all the contractors that attended our **2006 Construction Summit** as well as those that attended our year-end payroll seminars held during November.

As we look forward to 2007, we are expecting many changes in both the accounting and tax arenas. Many of the tax cuts and deductions passed as part of earlier Tax Acts are scheduled to expire in 2007 and beyond. In addition, the effects of the recent elections are yet to be seen. On the accounting side of things, more accounting changes are expected as the Financial Accounting Standards Board (FASB) continues to work with the International Accounting Standards Board (IASB) to bring accounting standards used by

companies in the United States of America more in line with those used in the international community. One can also expect continued changes in accounting standards passed for public companies to be pushed down onto private companies. We have already seen this happen in several areas including the consolidation of financial statements of related parties and new auditing standards requiring more and more documentation of a company's internal controls or lack thereof, which is the case with most smaller, private companies.

Finally, we would like extend a special **"Thank you!"** to all of our clients who have made the past year so enjoyable.



Merry Christmas and Happy New Year from all of us at Kentner Sellers!!



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## IRS Audits and Fringe Benefits



*by Marvin J. Homan,  
CPA/CCIFP*

With the printing of W-2s right around the corner, we thought it would be a good time to cover some fringe benefits that would undergo scrutiny in the event your Company should become the subject of an IRS audit. This list is not all-inclusive.

### **Personal Use of Company Autos**

If an employee, including an owner, uses a company vehicle for personal use, then that personal use is taxable to the employee or owner on his or her W-2. Personal use includes commuting to and from work as well as any personal use that is not considered de minimis. If an employee drives their own vehicle to the Company's office and then drives the Company truck to the job site, then there is no personal use. If an employee drives the vehicle home every night, then the commute from home to office is considered personal and should be factored into the calculation. The amount to be added to an employee's W-2 depends on whether or not the employee is a field employee or officer and whether the Company pays for fuel or not. If any of these situations apply to employees in your business, then consult your tax advisor for the correct calculations.

### **Fringe Benefits for more than 2% Employee-Owners of S Corporations**

The tax treatment of fringe benefits paid to employees of an S corporation is different for owner-employees than from other employees. Fringe benefits paid to S corporation employees who are not shareholders, or who own two percent or less of the outstanding S corporation stock, are tax free. They can be excluded from the employees' taxable wages and are deductible as fringe benefits by the S corporation. Employee-owners owning more than 2% of the S corporation's stock, on the other hand, are not treated as employees for fringe benefit purposes, and their fringe benefits may not be tax free. Owners and their families are not allowed to participate in a Company's Section 125 plan where employee-paid premiums are withheld pre-tax. Additionally, premiums paid by the Company on the behalf of a more than two percent owner must be added to the owner's W-2. Finally, the owner may get to deduct 100% of the health insurance premiums on page one of his or her Form 1040.

In determining who is subject to these more than 2% owner-employee rules, an owner-employee is defined as the owner, his or her spouse and any dependants. Consult your tax advisor for proper treatment of your Company's situation.

## IRS Audits and Fringe Benefits continued

### Group Term Life Insurance

An employee must include in income the cost (based on the IRS uniform premium cost tables) of more than \$50,000 of group-term life insurance provided by an employer.

For example, X Corp. pays the premiums on a \$70,000 group-term life insurance policy on the life of one of its employees with the employee's wife as beneficiary. The employee is 51 years old at the end of 2005. Per the 2006 IRS Tables, the cost for \$1,000 of group-term life insurance coverage for twelve months is \$2.76. The cost of the policy to be included in the employee's gross income is:

Total Insurance Coverage	\$150,000
"Tax-Free" Insurance	\$ <u>50,000</u>
Insurance coverage subject to tax	\$ <u>100,000</u>

The taxable cost of the policy includible in the employee's gross income is **\$276** (\$2.76 times 100).

An employee's age is determined as of the last day of the employee's tax year. Also, any amount paid by the employee toward the purchase of group-term life insurance coverage on the employee's life during the tax year reduces the amount includible in gross income.

### Allowances Paid to Employees

Many contractors pay their employees a car allowance or tool allowance. If these allowances are paid to the employee regardless of substantiation (non-accountable plan), then the allowances are considered compensation to the employee. The employee must include 100% of the allowances paid on his or her W-2, and the Company gets a 100% deduction for the allowance paid. Some Company's use an accountable plan requiring employees to provide substantiation for their expenses. Under a plan of this type, any payments (allowances) made by the Company to the employee in excess of the amount substantiated is considered compensation and should be added to the employee's W-2. For more information on tool allowances and their taxability, visit our website <http://www.kentnersellers.com/construction-services.html>

#### **Did you know?**

Form 1099s are required to be sent to any unincorporated business (individuals and partnerships) when \$600 or more of services are purchased. Often the difficulty is not in determining whether the vendor meets the \$600 threshold, but whether the vendor is incorporated or not. Businesses can use Form W-9 **Request for Taxpayer Identification Number and Certification** which can be downloaded at [www.irs.gov](http://www.irs.gov)

## CHANGES IN 2006 AND BEYOND



*by Marvin J. Homan,  
CPA/CCIFP*

In this section, we'll try to make you aware of some of the changes that have occurred in the past year and let you know how they affect you, the contractor.

### **Workers Compensation**

Effective with the reporting period beginning July 1, 2006, the Bureau of Workers Compensation has changed the minimum and maximum weekly limits as they relate to officer compensation. Prior to July 1, 2006, there was no minimum limit and the maximum wage limit for officers was \$800 per week. Starting July 1, 2006, the minimum wage limit for officers is \$352 per week and the maximum wage limit is \$1,056 per week. These new limits apply only to officers who are actively involved in the daily operations of the business..

It's worth noting that the new officer maximum is the same as the weekly maximum wage limit for all non-officer construction workers in effect for 2006. The Bureau just released the 2007 weekly limits for construction worker wages, which will be \$1,095 per week.

### **Domestic Production Activities Deduction**

In May 2006, final regulations were issued regarding the Domestic Production Activities Deduction (DPAD), which contractors are eligible to take. In 2006, the IRS clarified that profit related to the markup of materials **does not** have to be excluded from the calculation of the deduction. This exclusion greatly reduced the deduction for many subcontractors in 2005. The deduction is 3% of the lesser of 1) taxable income for C corps or adjusted gross income for pass-through entities; 2) production income; or 3) 50% of W-2 wages. The deduction is taken on the Form 1120 for C corporations and Form 1040 for owners of pass-through entities. Sorry, no amendments are allowed for 2005 related to the 2006 rule clarifications.

### **Like-Kind Exchanges**

In 2006, the accounting rules governing trade-ins were modified. The old rules allowed the deferral of a gain on the trade-in of an old asset and to reduce the cost of the new asset by the amount of the gain. The new rules may require this gain to be reported on the Company's income statement if the transaction has commercial substance, a new term introduced in the new rules. These new rules are effective for June 2006 year-ends and apply only to

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## CHANGES IN 2006 AND BEYOND continued

financial statement presentation. They do not affect the tax treatment of trade-ins.

### **Deferral of Retention Payable**

In 2006, the Internal Revenue Service de-coordinated its position on the deferral of retention payable on long-term contracts. The IRS is now allowing retention to be excluded from cost incurred to date when calculating a contract's percentage of completion. This change will mostly benefit contractors who report their long-term contracts on the percentage of completion method for tax purposes and have large amounts of retention payable. Any change to exclude retention from the percentage of completion calculation requires a Form 3115 Application for Change in Accounting Method to be filed with the IRS. We suggest a cost v. benefit analysis be done before any changes are made.

### **State Unemployment Taxes (SUTA)**

Effective January 1, 2007, the maximum amount of wages subject to state unemployment tax will increase from \$9,000

to \$9,500. This is the first adjustment to the wage limit in quite a few years. Contractors need to be aware that the new limit will raise the amount of SUTA that will be due. Contractors who prepare their own payroll will want to make sure their system is calculating the Company's state unemployment tax liability using the new wage limits.

### **Claim Revenues**

The IRS issued a Coordinated Issue Paper (CIP) in July 2006 that states that claims must be added to contract revenue when 1) there is legal basis for the claim; 2) when unforeseen costs were incurred; 3) when costs are identifiable; 4) and evidence of the claim is objective. When these criteria are met, the IRS's position is claim revenue must be reported at least to the extent of costs incurred related to the claim. If you have claims in process at year-end, we suggest you contact your tax advisor for proper treatment of any claims in relation to this Coordinated Issue Paper when preparing your annual tax returns.

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## Other Tax Info and Due Dates

### Selected 2007 Limits and Rates

401(k) Contribution limit - \$15,500

Additional catch-up 401(k) contributions if  
over the age of 50 - \$5,000

SIMPLE Plan Contribution Limit - \$10,500

Social Security Maximum Taxable Earnings  
- \$97,500

2007 Mileage Rate - 48.5 cents per mile

### 2006 Personal Income Tax Rates for Married Filing Jointly Couples

Taxable Income between \$0 and \$15,100 is  
taxed @ 10%

Taxable Inc. of \$15,101 to \$61,300 @15%

Taxable Inc. of \$61,301 to \$123,700 @ 25%

### Income Tax Brackets continued

Taxable Inc. of \$123,701 to \$188,450 @ 28%

Taxable Inc. of \$188,451 to \$336,550 @ 33%

The top rate of 35% applies to taxable  
income earned over \$336,551.

### Upcoming Due Dates in 2007

January 15 - 4th Qtr IRS and State of Ohio  
Estimates Due

January 31 - W-2s and 1099s must be  
distributed to employees and third parties

February 10 - Ohio CAT tax due

February 28 - W-2s and 1099s must be sent  
into the Social Security Administration and  
IRS