FEATURE

Special Tax Planning Considerations for Contractors – 2017 EDITION

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Contractors have it rough. It's a competitive, low-margin business; good help is hard to find and keep; and financial strength can swing from one extreme to the other overnight. Fortunately, the tax code gives contractors a few breaks that can save money if management and accounting personnel understand what they are, how to use them, and plan and act accordingly before the year is complete. Contractors must be sure to retain their financial strength while considering strategies to minimize tax liabilities, making planning prior to year-end a priority for contractors more than almost any other industry.

Unique to 2017, is the Republican plan to "simplify" the tax code via mass overhaul. As of the writing of this article, no bill has advanced past the early stages of debate. While the final bill – assuming one survives the process – may look nothing like the current proposals from either legislative body, contractors should perform their year-end planning with the proposed changes in mind and armed with the knowledge of what is on the table after 2017. Below are some of the more significant proposals, their impacts to the construction industry, and planning considerations for 2017 taxes and beyond.

CONGRESSIONAL TAX REFORM PROPOSALS

Individual Taxes

1) Tax Brackets – The House plan reduces the number of individual tax brackets to four (12%, 25%, 35% and 39.6%), while the Senate plan keeps seven brackets, ranging from 10% to 38.5%.
2) Deductions – The standard deduction would increase to $24,000 for married-filing-jointly returns, and many itemized deductions would be eliminated. Historically, only about 70% of filers take the standard deduction, and an increased standard deduction would allow even more to disregard itemized deductions altogether. Changes are also proposed for the deductions that would remain, such as charitable contributions, mortgage interest expense and property taxes.
3) Credits and Other Deductions – Many other credits and adjustments would also be cut out after 2017. The House plan calls for the elimination of the alimony deduction while the Senate retains it. The electric vehicles and work opportunity tax credits are eliminated, and the exclusion of gain from the sale of your personal residence will be phased out if you make more than $500,000. The deduction for domestic production activities (DPAD) – beneficial to manufacturers and contractors alike – would end.

4) Alternative Minimum Tax (AMT) – Under both the House and Senate plans, the AMT would be repealed for individuals and corporations. Credits for AMT paid prior to 2018 would be available to offset regular tax liabilities through 2022. AMT repeal would remove an entire element of tax planning and eliminate surprise AMT liabilities to which contractors are especially prone.

Business Taxes

1) Corporations – Rates for C-corporations would be lowered to a flat 20%, and 25% for personal service corporations (engineers, accountants, doctors, etc.). The United States currently has the highest corporate tax rate in the world (combined federal and state rate of 39%), and this reduction would place us slightly above the global average of 23.75%.
2) Pass-Through Business Income – Income from pass-through entities (S-corporations, LLCs and sole proprietorships) would be limited to a maximum rate of 25%. Passive owners in these companies would have a straight-forward computation of tax liability while active owners may face a complicated method that taxes a portion of this income at the 25% rate and the remainder at their regular individual rate.
3) Accounting Methods – Both proposals increase revenue thresholds in order to relieve smaller businesses of more stringent accounting methods that provide less opportunities for tax deferrals. Today, construction contractors reporting in excess of $10 million in average annual gross receipts must calculate taxable income using the percentage-of-completion method. The House bill increases this threshold to $25 million while the Senate plan increases it to $15 million, both indexed to inflation going forward. Contractors below the applicable threshold, will be able to use other, "friendlier" methods as discussed below.
4) Self-Employment Earnings – Active owners of S-Corporations and rental real estate businesses would no longer enjoy the privilege of avoiding self-employment taxes (Social Security and Medicare) on their business' earnings.
5) Accelerated Depreciation – Both plans call for immediate 100% bonus depreciation expense on the purchase of new assets through 2022. Businesses may currently take an immediate 50% deduction on the purchase of new assets, an incentive that was set to phase-down and expire after 2019. Both plans also call for an increase in the Section 179 deduction. Currently, businesses are allowed up to $510,000 of deductions on the purchase of

property and equipment, limited by net income. The House bill proposes increasing the deduction to $5 million while the Senate plan would allow up to $1 million.

6) Like-Kind Exchanges – Under current law, gains on property and equipment trade-ins are deferred indefinitely. Each of the new proposals would limit this deferral to the exchange of real property only. Contractors who routinely trade in used equipment for new would be faced with potentially significant tax liabilities as a result.
7) Net Operating Losses – Losses from one tax year may serve to offset income in future years, but tax reform may limit the deductibility of these losses to 90% of net income. The plans would also allow these losses to be carried forward indefinitely, contrasted to the current limitation of 20 years.
8) Meals and Entertainment – Currently limited at 50% deductibility, expenses for entertainment, amusement or recreation, and membership dues would be 100% non-deductible after 2017.

TAX PLANNING CONSIDERATIONS FOR CONSTRUCTION CONTRACTORS

Tax Methods of Accounting

The tax code provides construction contractors with the unique opportunity to choose among several different methods of accounting to recognize revenues and expenses. The contractor may also use multiple methods to recognize income from different types of work performed. Nearly every other industry is forced to choose only between the cash or accrual method. The type of work the contractor performs, length of contracts, and the nature and timing of cash flows should all be determining factors when electing or changing filing methods.

1) Overall Methods of Accounting
   a. Cash Method – This method is available to C-corporation contractors with less than $5 million in average annual gross receipts and S-corporations and LLCs with less than $10 million. These threshold amounts are subject to increase after 2017, as noted above. Essentially, tax is calculated off the amount of revenue constructively received less payments made. Businesses may control their tax liability to an extent by accelerating payments to vendors before the fiscal year ends.
   b. Accrual Method – The accrual method is generally the least favorable method to contractors. Many contractors will be "overbilled" on uncompleted contracts at year-end. Since overbillings are included in revenue under the accrual method, the contractor is taxed on these unearned revenues. Entities utilizing the accrual method can control their positions by waiting to invoice clients until the following year.
   c. Accrual Excluding Retainage – Retainage on contracts exempt from Section 460 is excluded from income until the jobs are complete. This method is not available to contractors who have elected the cash method as their overall method, but retainages could create a significant deferral depending on the nature of the business. An example of a contract that is exempt from Section 460 is one that begins and ends within a single tax year. Any retainage receivable on such a job at year-end would be excluded from revenue.
   d. An election to change from cash to accrual method, or vice versa, is considered automatic. To elect a method change, Form 3115 can be filed at any time before the due date of return.

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2) Methods of Accounting for Long-Term Contracts
    a. Completed Contract Method (CCM) – This method is especially advantageous for contractors with significant amounts of uncompleted contracts at the end of the year. Under this method, no profit is recognized from a job until it is complete. Like the cash and accrual methods above, the completed contract method of accounting for long-term contracts is only available to small contractors under the $10-million threshold, and for certain individually exempt contracts.
    b. Tax Percentage of Completion (Section 460) – The IRS requires this method to account for long-term contracts – defined as a contract that spans from one tax year to another – unless a specific contract is exempt.
        i. This method is similar to the percentage of completion method that may be familiar from General Accepted Accounting Principles (GAAP) financial reporting. Unlike GAAP, Section 460 requires the contractor to allocate general and administrative expenses to job costs. This can create tax deferrals on uncompleted jobs by increasing the total costs to complete a contract, and ultimately reducing profit recognized for tax purposes.
        ii. The IRS does not allow the contractor to deduct accrued job losses. Under GAAP, if a loss is expected upon job completion, the total estimated amount of that loss must be accrued in the current year. The tax code only allows the loss recognized in the current year. During planning, the contractor should be conscious of this potential "add-back" to arrive at taxable income.
    c. Contracts Exempt from Section 460 – Any contractor whose gross receipts do not average above $10 million over the prior three years (or more if tax reform is successful) is exempt from the rules of Section 460. The section also exempts certain individual contracts from the method, allowing the contractor to use its overall method (CCM, cash, or accrual) instead. Exempt contracts include:
        i. Non-Long-Term Contracts – Contracts that begin and end within a fiscal year. Key potential deferrals from these types of jobs would include any retainage receivable.
        ii. De Minimis Contracts – Contracts that are less than 10% complete at the end of the tax year.
        iii. Home Contracts – Defined as structures with four or fewer dwelling units. Along with de minimis jobs, these contracts are exempt from both Section 460 and the alternative minimum tax.
        iv. Residential Contracts – These contracts are partially exempt. 70% of the contract's gross profit would be accounted for using the percentage of completion method, while the other 30% would use an overall method such as completed contract. This would serve to defer 30% of the gross profit until the job is complete. Not to be confused with home contracts, residential contracts refer to structures with more than four dwelling units and an average occupant stay of more than 30 days. These contracts include apartment buildings, military barracks, long-term care facilities and prisons.

Project Taxable Income through Year-End

Management must be careful to project taxable income (determined by filing method) through year-end separately from financial income projections. If the percentage of completion method is required, projected taxable income for the remaining months should be similar to that for financial statement purposes. A cash method filer should be ultimately concerned with the amount of cash payments to be received and expenses paid before year-end while a completed contract method filer would only be concerned with projects completed by the end of the year.

Management and accounting personnel must convene in order to generate an accurate estimate, and should compare that estimate with prior years. If prior year estimates turned out to be different than expected, assumptions or methodologies may need adjustment. Each uncompleted job should be examined at this time to determine what characteristics may affect income through the rest of the year (weather, regulatory delays, etc.).

Tax Depreciation Methods

Contractors should expect large differences between financial and tax depreciation amounts. With no end in sight, accelerated depreciation in the tax code remains highly beneficial to asset-intensive industries. Property and equipment purchased in the current year should be reviewed thoroughly to determine which purchases are eligible for special depreciation allowances such as bonus depreciation and Section 179. For 2017, bonus depreciation allows for an immediate deduction of 50% of the cost of new equipment with no limitations. Under Section 179, the cost of new or used assets may be fully written-off, but the deduction is limited to net income. Management should determine what additional equipment will be needed before year-end and the impact each will have on the company's tax position. Equipment that may not be needed until early the following year may provide significant tax savings if purchased in advance.

Management should also consider a policy whereby certain purchases or repairs are automatically expensed rather than capitalized. IRS rulings allow for the automatic expensing of assets under $5,000 if audited financial statements are issued by the taxpayer. The limit is $2,500 if such statements are not produced. This not only saves on taxes, but also provides a certain level of IRS audit protection and relieves staff of the tedious work of accounting for depreciation on insignificant assets.

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Alternative Minimum Tax (AMT)

While it appears as though the AMT may have seen its final year in 2017, it is still in effect, and it can still jump up and bite a taxpayer if disregarded in planning. Specific to contractors at the entity level, deferrals on long-term contracts created through the use of the cash, accrual, or completed contract methods discussed above can create significant AMT liabilities. Essentially, the difference between the gross profit from the use of one of these methods and the gross profit that would have been recognized had the company used the percentage of completion method is what creates an AMT liability. Contracts exempt from Section 460, such as home contracts, non-long-term jobs and contracts less than 10% complete, are also exempt from AMT. Bonus depreciation and Section 179 deductions can also help to minimize an AMT liability, as those amounts are also exempt from AMT. If the corporation or owner(s) has paid AMT in prior years, they may be eligible for AMT credits going forward that would offset a regular tax liability.

Tax Credits and Deductions Specific to Contractors

While some of these may be gone next year, 2017 planning should take each of these into consideration:

1) Domestic Production Activities Deduction (DPAD) – DPAD is on the block in both Congressional proposals. The incentive is essentially a deduction equal to 9% of net income limited to 50% of wages paid. The deduction passes through to the individual owners of S-corporations and LLCs.
2) Research and Development credits – Management should consult a tax professional regarding this credit. Many contractors perform qualified R&D activities on a routine basis without recognizing the fact.
3) Work Opportunity Tax Credit – Hiring veterans, welfare recipients and even felons may provide significant tax credits if certain conditions are met. The paperwork must be completed within 28 days of new-hire, and the employee's tenure with the company is the predominant factor in calculating the credit. Both legislative proposals call for the termination of this program.
4) Federal Empowerment Zone credit – This credit focuses on the residence of employees and where they work, including jobsites. If both fall within an empowerment zone, the employer may be eligible for this credit.
5) State tax credits – The IRS is not your only taxing authority, and many states offer significant tax credits to offset the liabilities they impose. Management and/or accounting professionals should be aware of any credits available in each state of operation.

Related Entity and Pass-Through Liabilities

Today, most companies are established as S-corporations or LLCs, meaning the gain or loss from those businesses passes down to the owners of the company. The tax effect of each ownership interest can change the individual's tax position significantly. Tax planning for pass-through entities should be ultimately focused on the impact to individual owners. Basis considerations and deductibility of losses from related entities should be addressed. Significant losses from another business may negate any DPAD the owner recognizes from a profitable business, for instance. Holistically approaching the tax situation for the owner(s), including required estimated tax payments, bonuses made before year-end, net operating loss carryforwards, and AMT considerations should all be integral to year-end planning.

Once the planning process is complete, appropriate action must then be taken. Bonuses should be paid out as necessary along with distributions to owners required for estimated tax payments. Tax planning can reduce not only the current year tax liabilities, but also reduce estimated payment requirements in the following year. Payroll withholdings on individual owners are an excellent way to minimize underpayment penalties on estimated taxes. Considerations for gifting and estate tax purposes may also be necessary (also subject to significant change under tax reform).

The intricacies of tax law provides numerous planning opportunities to contractors. Cash flow is the ever-important lifeblood of any business, but it is especially vital to a growing contractor. Maximizing tax deferrals and consequently delaying liabilities is the primary focus of planning activities. A review of the company's financial and tax positions prior to year-end must be conducted each year by all interested parties. Failure to do so will undoubtedly create unsavory surprises, lost profits, or both. While there is still time, conduct your planning and position yourself for next year. Most of your competition will just do something else.

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