Construction Executive

CE This Week

Take Advantage of Deferred Tax Liability for Construction Contracts

By Don Singleton, Kenneth Padgitt | Tuesday, February 27, 2018

The U.S. tax code is complicated and confusing. The evolution of the federal income tax law over the decades has been a constant tug-of-war, riddled with the strength of special interest lobbying, attempts to correct economic and social ills, and implementation of governmental spending disguised as tax cuts and credits—all laced with political agendas. Well-intended desires to instill fairness in the tax system have added to its complexity.

While the tax code may be hard to understand, one thing is self-evident: it's better to pay taxes later than sooner, as most taxpayers prefer to legally defer tax liabilities to the distant horizon. However, a hint of whether a contractor is taking advantage of all available deferrals can be found in the amount and nature of the deferred tax liability (DTL) presented in the company's financial statements. The size and composition of the DTL can provide enough ammunition to ask a few questions of its tax advisor.

There are numerous ways that tax reporting for construction contracts can create taxable temporary differences and thus a DTL for financial reporting. This is a good thing and can cautiously be described as a "good" liability. It means tax payments are deferred and cash flow is improved. This article will focus on tax techniques that create these sought-after taxable temporary differences related to construction contracts.

LONG-TERM CONSTRUCTION CONTRACTS

Taxable temporary differences give rise to deferred tax liabilities for financial reporting. As previously stated, this may cautiously be viewed as a good liability on a contractor's balance sheet because they are reporting income in their financial statements now, but delaying the payment of the related income taxes to a future day. Additionally, a recent change in GAAP requires all deferred income taxes be presented as long-term on the balance sheet and therefore will not punish working capital if it's a net DTL.

The most significant caveat to a DTL, however, is that when it's time to pay the piper, the cash must be available. During an up business cycle, profitable backlog may be increasing at each year. So deferred tax liabilities that come due are replaced with new additions to the DTL. Therefore, the deferred tax liability may essentially remain stable or perhaps increase. However,

in a down business cycle, the opposite may happen. That is, as the backlog of work decreases, more of the prior year's deferred tax liability becomes due currently. While a healthy deferred tax liability may be symptomatic of sound tax planning and preparation, care must be taken to assure that cash is available to pay current tax liabilities as the deferrals reverse during down cycles.

ANALYZING DTAS

When reading financial statements, pay close attention to the amount and disclosure for deferred income taxes. Do you have a deferred income tax asset on your balance sheet? That should raise your eyebrows. Keep in mind that deductible temporary differences (DTA) occur because of deductible temporary differences. DTAs decrease future taxable income. In other words, future taxable income will be less because current taxable income (and the tax the contractor is paying now) is more.

For a construction company, a DTA can be a red flag. It may possibly indicate that it is not taking advantage of all the tools available to defer taxes to future years. There should be a section that details the major components of the DTA. If it’s caused by a sizable net operating loss carryforward or a tax credit carryforward, then it probably makes sense. No need for alarm.

However, if the DTA is generated by such deductible temporary differences as reserves for accounts receivable, warranty reserves and inventory, then further questions are warranted. In a construction environment, long-term construction contracts can spin off sizable taxable temporary differences that may offset the aforementioned deductible temporary differences. This results in a net deferred income tax liability, which is indicative that income tax is deferred to later years. If a construction company doesn’t have a net deferred tax liability, ask questions.

Even if the balance sheet or footnotes (for flow-through entities) has a net deferred tax liability, it may not be as large as it should be. Depreciation differences between financial and tax reporting can be sizable and create large DTLs. This is a common deferral triggered by accelerated and bonus depreciation permitted under the tax code. But the contractor wants to see more than that. If it doesn’t see a DTL component described as revenue recognition methods, or similar nomenclature, it’s probably not taking full advantage of the income deferral tools available under the tax code and described in this article.

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