# Construction Executive
# Managing Your Business

## Plan Now for Tax Season Take advantage of all available credits and deductions by planning ahead

By James Lundy
Published On: Tuesday, November 28, 2017 10:34 AM

More than almost any other industry, construction contractors need to spend time and resources planning for their income taxes before the end of their fiscal year. Contractors must be sure to retain their financial statement strength and ratios while considering possible tax methods of accounting, projected taxable income for remaining months, tax vs. book depreciation and the calculation of alternative minimum taxes and available tax credits for the entity and the pass-through owners. It is important that all these variables be considered to ensure the most favorable financial and tax objectives are achieved.

### Tax Methods of Accounting for Construction Contractors

Most industries have the choice of only one method of accounting, cash or accrual, depending on their revenue volume and nature of business. Due to the code sections, regulations and revenue rulings related to the construction industry, contractors have up to seven different methods available depending on their volume and the length and nature of their contracts. It is not unusual to find a contractor using up to four different tax methods on a single tax return.

#### Overall Methods of Accounting Available to Contractors

The **Cash Method** is available to C corporations with less than $5 million in average annual gross receipts, and partnerships and S corporations with up to $10 million in average annual gross receipts over their prior three years. Certain contracts exempt from long-term contract methods can remain on the cash method regardless of the company's size.

The **Accrual Method** is available to construction contractors, although not generally a good selection. Many contractors will be "overbilled" on their jobs, which can cause them to be taxed on amounts that have been billed but not earned for financial statement purposes. The IRS treats amounts as taxable when billed under the accrual method.

The **Accrual Excluding Retainage Method** is allowed to taxpayers with contracts that include retainage. Revenue Ruling 69-314 directs taxpayers to remove retainage receivable from taxable income until jobs are completed and accepted. Since most construction contracts include retainage in the amount of 5 percent to 10 percent of the contract revenue, this can result in a substantial tax deferral. Most contractors that have not elected cash as their overall method of accounting elect the

Accrual Excluding Retainage Method. It can apply to any contracts that are not subject to long-term methods of accounting.

Electing to change any of the overall methods is treated as automatic. A Form 3115 can be filed any time before the tax return is filed, including extensions. For example, for a December 2017 year-end, the election can be filed any time before September 15, 2018.

#### Tax Methods for Long-Term Contracts

**Percentage of Completion Method** is required for all long-term contracts per Code Section 460, unless exempted. Long-term is defined as any contract which starts in one fiscal year and is finished in another.

Tax Percentage of Completion includes adjustments to percentage of completion required by Code Section 460, including capitalizing many indirect and general and administrative costs to jobs, which also results in changes to estimated total costs and adjusting for loss contracts. When additional costs are allocated to jobs for tax purposes, it will result in a corresponding increase to the total estimated cost for tax purposes. This can produce a tax deferral as a job might be less complete for tax purposes than for financial.

**GAAP** requires 100 percent of contract losses to be reported for financial statements, regardless of actual percentage of completion. The IRS only allows losses equal to the percentage of completion. In addition, contracts that are less than 10 percent complete can be omitted for tax purposes.

**Completed Contract Method** is allowed for contracts that are exempt from the Percentage of Completion Method. These include contracts performed by small contractors (average annual gross receipts less than $10 million per year for the three previous years). This also includes home construction contracts. Home contracts are defined as any of those performed by contractors (or subcontractors) with four or fewer dwelling units per structure, and also includes common improvements such as sewers, roads and clubhouses contractually obligated or required by law.

**Percentage of Completed Capitalized Cost Method (PCCCM)** is allowed for residential contracts. Residential contracts are defined as the same as home contracts but include those with more than four dwelling units per structure, with an average stay of more than 30 days. These include most multi-family projects as well as college dormitories, assisted living facilities, military barracks and prisons. A contract that qualifies for PCCCM is accounted for 70 percent Percentage of Completion and 30 percent under the Elected Tax Method of Accounting (e.g. cash, completed contract, etc.).

## Projected Taxable Income for Remaining Months

After determining, or electing, the appropriate or allowable tax methods, it is important to project the taxable income for the year. Following are a few ways to project income.

- Meetings and discussions with management and internal and external accounting professionals prior to year-end is essential to generate accurate estimated income (or losses) for the year.
- Compare projections to prior year actual results. Consider why the current year would be better or worse than the prior year (weather, government budgets, etc.).

- Review taxable income or losses at related companies. Most contractors have related entities involving equipment or real estate rentals or additional construction trades. It is essential that losses or lower tax brackets not be wasted due to ownership, basis or participation.

## Tax Depreciation Methods for Contractors

Contractors are allowed several favorable methods related to depreciation and capitalization for tax purposes. Construction equipment is all depreciated over five years for tax purposes even though the GAAP useful life might be much longer. Contractors also are eligible for the beneficial tax depreciation methods, such as Section 179 (deduction equal to $500,000 if total purchases do not exceed $2 million) and 50 percent bonus depreciation on purchases of new equipment. In addition, due to the large cost and long GAAP useful lives of construction equipment, many repairs are currently deductible for contractors vs. required capitalization.

## Alternative Minimum Taxes for Contractors (AMT)

Due to the preferential tax methods available to contractors, alternative minimum taxes are a consideration. Proper use of these deferrals can result in such significant savings that the regular tax might be substantially lower than the AMT. Pre-year-end planning needs to include that possibility in the calculations. Following are pre-planning steps to take.

- Differences between the Tax Percentage of Completion Method and the methods used in the tax return for long-term contracts can create AMT. Home contracts, less than 10 percent contracts and non-long-term contracts are exempt from alternative minimum tax.
- Section 179 and bonus depreciation are not subject to AMT.
- AMT rates are lower than regular tax rates. (Note: most states do not charge an alternative minimum tax.)
- Alternative minimum taxes paid can be used as a credit against future regular tax expense.

## Tax Credits and Deductions Available to Contractors

Contractors are eligible for several tax credits or deductions that should be reviewed as a part of pre-year-end planning.

- A nine percent manufacturing deduction is available to contractors. Construction activities are included in the definition of manufacturing for purposes of qualifying for the deduction.
- Section 179D deduction is available to the parties involved in energy efficient construction. As an incentive to governmental agencies to use green construction, the contractor, engineer or architect can be awarded deductions of up to $1.80 per square foot.
- Research and development credits (up to 20 percent of qualified expenditures).
- Energy credits
- Work Opportunity credits (up to $9,600 for approved employees)

## Review Pass-Through Entities Tax Situation

It is essential that all tax planning take into account any tax liability at the company level, while also considering the tax burden of the pass-through owners. To do this, maximize the use of lower tax

brackets and deductions between companies and owners and calculate alternative minimum tax at the owner level if applicable. In addition, consider the timing and deductibility of payments between parties. Certain bonuses and other payments must be made prior to year-end to be deductible. Calculate before and after planning comparisons to review costs and benefits.

## Create a Detailed "To Do" List

Develop a detailed list of what needs to be done prior to year-end, including the following.

- Bonuses and withholding as required. (Amounts withheld prior to year-end can reduce the need for estimated tax payments.)
- Tax estimates or deposits required after planning (remember: tax planning can reduce the current year tax liability and the estimated taxes for the following year).
- Gifting or transfers related to estate and continuity planning.

There are many planning opportunities available to construction contractors. It is essential that the company's operations be reviewed prior to year-end while considering the savings available from tax methods, depreciation, related party payments and other tax deductions and credits. All interested parties (owners, management, internal and external accountants) need to be involved to ensure that any possible strategies have been considered and implemented while there was still time to do something about it.

James Lundy

James Lundy is a Tax partner in the Nashville, Tenn., office of Marcum LLP and is a member of the Firm's national Construction Industry Practice group. He is one of the most respected tax consultants in the construction industry and an accomplished speaker and author on construction tax-related issues. He can be reached at jim.lundy@marcumllp.com.