

# 2020 Tax Planning Opportunities for the Construction Industry

Sponsored by: **Foundation Software**  
Published: December, 2020



# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## FOREWARD

The Tax Cut and Jobs Act (TCJA) signed into law in late 2017 made some of the most significant tax regulation changes in decades and created many new planning opportunities for contractors. Changing entity types, accounting methods, new deductions for qualified businesses, new depreciation alternatives and new tax incentives for qualified investments are just some of the provisions in the TCJA that will require careful analysis and proactive planning for CPAs and their contractor clients.

On March 27, 2020 the President signed The Coronavirus, Aid, Relief and Economic Security Act (CARES Act). The CARES Act includes many tax provisions that are intended to put cash flow in the hands of individuals and businesses.

The CICPAC Tax Thought Leadership Committee has compiled a summary of those changes potentially impacting our construction clients for consideration. In the interest of timing, this document only provides an overview for further consideration for planning in 2020 and beyond. Our intent is to follow this summary with more in-depth guidance and practical application materials as we work through implementation of the new regulations and as additional information becomes available. See CICPAC issued whitepaper regarding *Tax Planning Opportunities – CARES ACT, released December 2020*.

Many thanks to the members of the Tax Thought Leadership Committee (below) for their contribution to the CICPAC organization and their collective efforts resulting in this document. We are also grateful to Kathleen Baldwin and Michelle Class for bringing it all together.

2018 – Initial Release of Document	
<b>Jackie Daenen, Daenen Henderson &amp; Co., Co-Chair</b>	<b>Matt Neely, MCM, Co-Chair</b>
Sara Andzeiczak, Iannuzzi Manetta	Warren Hennagin, Marcum LLP
Kristin Bailey, KatzAbosch	Kyle Kmiec, Calvetti Ferguson
Scott Bechtel, GBQ Partners	Chase Lister, Daenen Henderson & Co.
Cody Daniels, Mowery & Schoenfeld	Ben Lyon, Katz, Sapper & Miller
Tracie Dupuy, HORNE LLP	Tricia Neale, Thompson Greenspon
Eric Fletcher, Thompson Greenspon	Dan Shepherd, LUTZ
Kevin Golden, James Moore	
2020 – Update	
Carlo Ferri, Kreisler Miller	
Barry Fischman, Marcum LLP	
Cody Daniels, Mowery & Schoenfeld	

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## CONSTRUCTION ACCOUNTING METHODS

One of the most comprehensive changes included in the TCJA is the changes in tax accounting methods available for contractors. Methods previously only available to smaller contractors are now available for contractors with average annual gross receipts of up to \$26 million (as adjusted for inflation). In addition, IRS revenue procedures issued in 2018 and later provide that most of the allowable changes will be considered automatic.

Although automatic changes will still require a submission of Form 3115 to the IRS, the amount of detail and documentation is significantly reduced, user fees of up to \$10,800 are not applicable and prior approval by the IRS before adoption is not required so the form can be submitted with the tax return for the year. This provides additional time to analyze the impact of a potential change as well having available the actual year end numbers that will be affected while performing the analysis.

Since accounting methods only impact the timing of when income or deductions are reported it is considered revenue neutral. The timing changes however can result in deferral of tax liabilities. Some amount of deferral or increasing deferrals can result in permanent or at least long-term tax savings to companies: theoretically a win-win for the government and the taxpayers.

## LARGE CONTRACTORS

As noted above, under pre-TCJA regulations large contractors were considered to be those with average annual gross receipts of \$10 million and above. That limit is now raised to \$26 million (as adjusted for inflation) and above. Contractors meeting those revenue limits are still required to use the percentage of completion method (with some variations) to account for all long-term contract revenues. However, the IRS issued revenue procedures issued in 2018 that now include the ASC 606 Revenue Recognition Standards as an acceptable percentage of completion method. Contractors will need to analyze the impact of the standards on the timing of their revenues. If the implementation of the new standards for financial statement purposes generally results in reporting revenues later rather than sooner, a switch to this method for taxes also will result in deferred / reduced tax liabilities. An ancillary benefit would also be to minimize book / tax reconciliation differences.

Revisions to IRC Section 451(b) regarding timing of income recognition and new 451(c) related to advance payments should also be considered.

The charts on the following pages provide an overview of these new provisions as well the other accounting methods that have not been changed and are allowable for large contractors.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## Accounting Method Changes for Large Contractors

Description of Change	What Contractors May Benefit	Action Steps	Timing	Other Considerations
<b>Adoption of New Revenue Recognition Standards (ASC 606)</b>	Application of revenue recognition standards for GAAP, may slow or accelerate revenue for reporting purposes, depending on when taxpayer recognizes revenue under new performance obligation model set forth in new standards.	Goes into effect for calendar year 2019, but important to identify during 2018 process, potential impact areas for GAAP reporting and its impact for tax.	Any automatic change can be made in the taxpayer's first, second or third taxable year ending on or before May 10, 2021.	Outside of the current three-year window noted under 'timing', advance consent with the IRS would be required pending further guidance.
<b>Impact of Section 451(b) on Book-Tax Conformity</b>	New rule under TCJA, mandates certain accrual method taxpayers shall recognize gross income for tax purposes no later than taken into account in a taxpayer's applicable financial statement.	This binds closely with new ASC 606 standards above, as its important to understand potential GAAP differences and/or upcoming changes to GAAP revenue reporting. Even if do not elect to follow ASC 606 for tax purposes, 451(b) may require following similar concepts for consistency with financial statement reporting.	No need to file a Form 3115 if any required change (under new tax) is made immediately in the first taxable year after December 31, 2017.	Applies only if accrual method and have a required applicable financial statement (AFS). For closely held contractor clients this would normally mean an <u>audited</u> financial statement. The new rules do not apply to any specific items of gross income where a special method of accounting is used (i.e. - Sec. 460 Long-term contract method). Additional attention should be paid to the accrual less retainage method of accounting.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

<b>Impact of Section 451(c) on Advance Payments</b>	New rule under TCJA, mandates accrual method taxpayer must include advance payments in income when received, unless elected to defer for tax purposes to the first year only following receipt.	Identify if taxpayer receives advance payments and determine if any current inconsistencies between GAAP and tax reporting, and if the deferral on those payments exceeds 12 months.	No need to file a Form 3115 if any required change (under new tax law) is made immediately in the first taxable year after December 31, 2017.	This section largely tracks existing Revenue Procedure 2004-34, which allowed the deferral of advance payments in a similar manner pretax reform. Service contracts should be reviewed to determine whether any deferral opportunity exists.
---	---	--	---	--

## Accounting methods available to large contractors, over \$26 million (as adjusted for inflation) in average annual gross receipts, has not changed:

<b>Percentage of Completion (PCM)</b>	In general, taxable income from a long-term contract is determined under PCM.	If contractor moves from a defined small contractor to a large contractor due to revenue growth no formal election or method change needed. Apply PCM to the contracts started in the first year of application.	Incorporate into a entity tax return, including extensions.	Large contractors will typically be required to apply PCM to long-term contract. As noted under action steps if contractor moves between large and small under the definition of the \$26M (as adjusted for inflation), further considerations should be given.
<b>Percentage of Completion (PCM) - 10% Method</b>	Defer recognition of revenue under PCM until 10% of estimated total contract costs are incurred and allocated.	Election attached to tax return in the year adopting.	File with entity tax return, including extensions.	Unavailable if the taxpayer elected to utilize the simplified cost-to-cost method for PCM, versus standard "cost-to-cost" method.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## Percentage of Completion - Capitalized Cost Method (PCCM)

Ability for those contractors with residential construction contractors to report 70% of the contract under PCM, and the remaining 30% under exempt method (e.g. - completed contract).

Requires advance consent of the IRS by filing Form 3115.

Filed by the last day of applicable tax year.

Definition of residential contract in this regard means building with 4 or more units versus home construction contract which is 4 or fewer. Further definitions are key to review under IRC Section 460(e).

## Accrual Excluding Retainages

Defer inclusion in income of retainages withheld by customer until final acceptance by customer occurred as specified in the contract. Contract must be exempt from IRC Section 460 (short-term).

Requires automatic consent of the IRS by filing Form 3115.

File with entity tax return, including extensions.

Must also exclude retainage payable related to same short-term contracts.

## Accrual Excluding Retainage Payable

Retainage payable related to long-term contracts are not included in contracts costs until the retainage is payable to the subcontractor as defined in the contract. This slows the percent complete and reduces income recognition.

Requires advance consent of the IRS by filing Form 3115.

Filed by the last day of applicable tax year

Contract language is key is applicability.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## SMALL CONTRACTORS

The small contractor exception requiring the use of the percentage completion method has been expanded from contractors with average annual gross receipts of less than \$10 million to \$26 million (as indexed for inflation). Contractors not exceeding the \$26 million (as adjusted for inflation) limitation and previously using the percentage completion method to account for revenues from long term contracts now have broad range of choices for tax accounting methods.

In addition, IRC Section 448 has also been expanded to allow the cash method of accounting for companies with receipts of less than \$26 million (as adjusted for inflation). Revisions to IRC Section 471 eases accounting for inventories also allowing the cash basis for smaller companies.

Previously, changes in accounting for long term contracts would require advance notification and approval by the IRS. Changes for contractors no longer meeting the requirements for percentage completion or accrual basis of accounting requirements are now considered automatic. Form 3115 is still required but is submitted with the tax return for the year of change, no user fees apply, and the information required is significantly reduces. Changes from the percent complete method are made on the cut-off method so revenues from contracts in progress prior to the year of change will still be accounted for under the old method. Changes in overall methods, i.e. from accrual to cash, are made through a 481(a) adjustment. I.e. the effect of the change is determined at the beginning of the year of change and taken into income over four years if a positive adjustment and deducted in the year of change if negative.

The chart on the following pages provides an overview of these new provisions.

## Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

### Accounting Method Changes for Smaller Contractors

Description of Change	What contractors may benefit	Action Steps	Timing	Other Considerations
<p><b>Accounting for Long Term Contracts</b></p> <p>TCJA increased the exemption for requirements to use the percentage completion method of accounting for long term contracts for taxpayers with less than \$10 million in average annual gross receipts to less than \$26 million (as adjusted for inflation) in average annual gross receipts</p>	<p>Contractors with revenues less than \$26 million (as adjusted for inflation) currently using the % completion method</p>	<p>Completion and submission of Form 3115 under automatic change provisions</p>	<p>By due date of the return including extensions</p>	<p>Conversion applied on the cut-off method for contracts entered into after December 31, 2017</p>
<p><b>Other Methods Available:</b></p>				<p>Application may be made concurrent with other changes available under TCJA provisions</p>
<p><b>Completed Contract</b></p> <p>Revenues and costs for each contract is deferred until the job is at least 95% complete</p>				<p>For non-C corporation entities - beware of AMT issues on taxable income difference between method and percent complete income</p>
<p><b>Cash</b></p> <p>Revenue is recognized when cash is received and are deductible when paid.</p>				



## Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

<p><b>Accrual</b> Revenues recorded as available to be billed, Costs recorded based on economic performance occurs</p>				
<p><b>Overall Method Change from Accrual to Cash Method</b> TCJA increased the gross receipts threshold for the requirement to use the accrual method of accounting from \$5 million to \$26 million (as adjusted for inflation)</p>	<p>Contractors with revenues less than \$26 million (as adjusted for inflation) currently on the accrual method</p>	<p>Completion and submission of Form 3115 under automatic change provisions</p>	<p>By due date of the return including extensions</p>	<p>Conversion made through 481(a) adjustment determined at beginning of the year of change with negative adjustment applied in the year of change and positive adjustment taken into account ratably over 4 years</p>
<p><b>Accounting for Inventories</b> TCJA no longer requires accrual method of accounting if company revenues are less than \$26 million (as adjusted for inflation); inventory is non-incident material and supplies or accounting treatment is consistent with applicable financial statement</p>				

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## WHAT IS SECTION 199A AND WHO BENEFITS?

Section 199A provides a 20% deduction on the amount of Qualified Business Income (referred to as QBI and defined later) from a domestic business operated as a partnership, S-Corporation, sole proprietorship, trust or estate. This deduction is in response to the approximate 20% tax rate cut for C-Corporations and replaces the Domestic Productions Activity Deduction (DPAD).

Section 199A applies to all US (including Puerto Rico) non-C-Corporation taxpayers and is calculated at the individual taxpayer level. It is limited by each individual taxpayer's taxable income range and the industry in which they conduct their trade or business. Specified Service Trade or Businesses (referred to as SSTB and defined later) can reduce or eliminate the amount of deduction received. There are several other limitations which are discussed later in detail.

Section 199A puts all taxpayers into one of three categories (as indexed for inflation):

1. Those below the taxable income threshold (\$163,300 single / \$326,600 married filing joint)
2. Those above the taxable income threshold and within the phase-in range (\$163,300 - \$213,300 single / \$326,600 - \$426,600 married filing joint)
3. Those above the taxable income threshold and above the phase-in range

Depending on the category an individual taxpayer falls within certain limitations may apply.

## HOW IS "QUALIFIED BUSINESS INCOME" DEFINED?

Per IRC Sec. 199A(c), qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. QBI does not include any qualified REIT dividends or qualified publicly traded partnership income. Qualified items of income, gain, deduction, and loss mean items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States, and included or allowed in determining taxable income for the taxable year (Sec. 199A(c)(3)(A)).

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

Simply put, Box 1 or Box 2 from K-1s, Schedule C income, Schedule E rental income (pending further guidance from the IRS), and Schedule F farm income are all included in QBI. Also included are Sec. 751 gain or loss giving rise to ordinary income and Sec. 481 adjustments (if the adjustment arises in taxable years ending after 12/31/17). Previously disallowed losses under Secs. 465, 469, 704(d), and 1366(d) allowed in the taxable year are taken into account for purposes of computing QBI if the losses were disallowed after 12/31/17.

Items of income and deduction that are excluded from QBI include: short-term and long-term capital gains & losses, dividend income, interest income (other than interest income which is properly allocable to a trade or business), wages to shareholders, partner guaranteed payments, and Sec. 1231 gains (unless taxed at ordinary rates). Previously there was inconsistency regarding IRS treating charitable contributions as reducing QBI. The 2020 draft Form 8995 instructions remove reference to charitable contributions and resolved this inconsistency.

## HOW IS A “SPECIFIED SERVICE TRADE OR BUSINESS” DEFINED?

A Specified Services Trade or Business (SSTB) includes any trade or business involving the performance of services in the fields of:

- Health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services,
- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or
- Which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.

Based on the definitions in the final regulations issued by the IRS, certain professions that appear to be SSTBs are not. In general, construction activities are not SSTBs and should qualify for the 199A deduction.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## WHEN DO THE LIMITATIONS APPLY?

The income category of the taxpayer will determine the limitations on the 199A deduction. The three categories of income thresholds are listed above and the deduction can be limited by two major factors:

1. W-2 wages and qualified property
2. Whether the trade or business is an SSTB

### ***W-2 Wages and Qualified Property Limitation***

The deduction is limited to the lesser of 20% of the qualified business income OR the greater of 1) 50% of the W-2 wages relating to the qualified trade or business and 2) the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis of qualified property.

If the taxpayer falls in the first category (under the income threshold of \$163,300 single / \$326,600 married filing joint), the wage and qualified property limitation do not apply. The limitation is phased in over the income above the threshold for the taxpayers who are in the second category (\$163,300 - \$213,300 single / \$326,600 - \$426,600 married filing joint). Taxpayers in the third category (above the thresholds) apply the wage and qualified property limitation in full.

### ***Specified Service Trade or Business Exception***

As stated above, a SSTB taxpayer may not be able to claim any or the full 199A deduction otherwise allowed based on the income category that applies to the taxpayer. The same categories apply to the SSTB exception in a similar way to the wage and qualified property limitation.

The SSTB exception does not apply to taxpayers in the first category. Therefore, even a SSTB taxpayer below the income threshold can claim the 199A deduction. The deduction amount of an SSTB taxpayer is phased out over the income range for SSTB taxpayers in the second category. For a SSTB taxpayer in the third category, the 199A deduction is prohibited on the corresponding SSTB income.

Because most construction companies will not fall under the SSTB designation, the wages and qualified property limitation will be the most significant consideration in determining the 199A deduction. However, you would need to evaluate the de minimus rules to confirm whether any issues exist.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

The following examples illustrate the application of the 199A deduction in various scenarios.

## HOW DO WE APPLY THE 199A?

### Income Above Threshold Amounts – Wage-Intensive Business

	Business Other than Specified Service Business	Specified Service Business
Partner's Share of Qualified Business Income	\$ 1,000,000	\$ 1,000,000
Partner's Share of W-2 Wages	\$ 200,000	\$ 200,000
Partner's Share of Unadjusted Basis of Qualified	\$ 10,000	\$ 10,000
20% of Partner's Share of Qualified Business	\$ 200,000	\$ 200,000
Deduction	\$ 100,000	\$ 0
(Apply 50% of W-2 wage limit)		

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## Income Above Threshold Amounts – Capital-Intensive Business

	Business Other than Specified Service Business	Specified Service Business
Partner's Share of Qualified Business Income	\$ 1,000,000	\$ 1,000,000
Partner's Share of W-2 Wages	\$ 50,000	\$ 50,000
Partner's Share of Unadjusted Basis of Qualified Property	\$ 1,000,000	\$ 1,000,000
20% of Partner's Share of Qualified Business Income	\$ 200,000	\$ 200,000
Deduction	\$ 37,500	\$ 0
(Apply 25% of W-2 / 2.5% unadjusted basis limit)		

### WHERE DO WE GO FROM HERE?

Because the regulations related to 199A were recently finalized, we may continue to have questions regarding specific applications to each taxpayer. As we approach year end, we need to consider how each of the following will impact the 199A deduction of taxpayers.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## WAGE LIMITATION

Wages play a major role in the calculation of the 199A deduction. Below are three scenarios

	<b>A</b>	<b>B</b>	<b>C</b>
Wages (including owners)	\$ 400,000	\$ 200,000	\$ 300,000
Taxable income	\$ 600,000	\$ 800,000	\$ 700,000
20% of QBI	\$ 120,000	\$ 160,000	\$ 140,000
50% of wages	\$ 200,000	\$ 100,000	\$ 150,000
199A Deduction	\$ 120,000	\$ 100,000	\$ 140,000

In Scenario A (most construction companies) – the deduction is limited to 20% of QBI. Therefore, reducing owner’s wages and increasing QBI will increase the deduction. Consider paying quarterly estimates instead of a bonus to pay safe harbor amounts. If the owner reduces his wages by \$100,000, and takes a distribution instead, the deduction is increased by \$20,000. Please remember to watch reasonable compensation.

In Scenario B (possible for construction management and A&E firms) – the deduction is limited to 50% of the wages. Therefore, increasing owner’s wages will increase the deduction. As with any planning technique, consider the cost of increasing payroll expenses versus the benefit of increasing the 199A deduction.

In Scenario C – this is close to the optimum wage to QBI percentage, 50% of wages approximates 20% of the QBI.

Another area relating to wages are leased employees, if you have a developer who maintains a separate partnership for all projects but uses one entity for payroll, the payroll can be allocated to the end users of the payroll, thus increase the 199A deductions.

Subcontracting is very common in the construction industry and subcontractor fees do not qualify as wages. If your company heavily relies on subcontracting you may want to consider who you can include on payroll to maximize your 199A deduction.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## PROPERTY LIMITATIONS

Another limit of the deduction is 2.5% of unadjusted basis on qualifying property plus 25% of wages. Property no longer qualifies after 10 years from the original placed in service date or the last day of last full year in the applicable recovery period determined under section 168. If this factors into the 199A deduction, it should factor into property replacement decisions.

## AGGREGATION RULES

A taxpayer can potentially choose to aggregate businesses for the deduction if the taxpayer operates multiple businesses in coordination with each other, shares resources, and are commonly controlled. How a taxpayer groups or doesn't group businesses for purposes of applying the passive activity loss rules doesn't affect how the taxpayer can aggregate or not aggregate businesses for purposes of applying the QBI deduction rules. After a taxpayer chooses to aggregate two or more businesses for QBI deduction purposes, he or she must continue to aggregate the businesses in all subsequent tax years.

## OTHER CONSIDERATIONS

If the business income does not qualify for the 199A deduction consider additional wages to reduce the income to an amount under the threshold and look at other deductions such as bonus depreciation, Section 179 depreciation, and retirement or SEP contributions. Conversely some taxpayers may need to reduce the amount of deductions to optimize their 199A deduction.

Consider extending the 2020 tax return as the IRS is continually releasing clarifications and some technical corrections are expected. In addition, there remains significant uncertainty with certain provisions of the CARES Act, primarily related to the deductibility of expenses funded with PPP loan proceeds and the impact to various other code sections. We eagerly await a legislative correction to override the IRS recent rulings and interpretations.

In summary, Section 199A can provide a tax benefit but how to best derive that benefit can be vastly different taxpayer by taxpayer. It is highly recommended you consult the CICPAC group and your tax advisor to discuss any planning needs.



# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## OTHER OPPORUNITIES / CONSIDERATIONS UNDER TCJA

### EXCESS BUSINESS LOSSES

The TCJA brought in some unfavorable rules around the deductibility of excess business losses. The maximum annual business loss is now \$500,000 for joint filers and \$250,000 for singles. As indexed for inflation, the threshold amount is \$510,000 / \$255,000 (2019) and the threshold amount is \$518,000 / \$259,000 (2020). These rules apply at the taxpayer level for pass-through business income (or schedule C business income) and do not apply to C corporations. There has been no guidance issued on whether related business can be aggregated to offset a loss greater than \$500,000. One interesting item to note is how the carry forward losses change from year 1 year to year 2. Excess losses are carried forward to future years as Net Operating Losses, so they are not subject to the \$500,000 maximum limitation but are limited in the same way NOLs are limited. (See discussion below)

#### Business Losses for Non-Corporate Taxpayers – CARES Act

**For non-corporate taxpayers who under TCJA were limited to using net business losses to the extent of \$250,000 (\$500,000 for married filing joint). Taxable incomes for 2018, 2019 and 2020 can be computed without this limitation.**

### CHOOSING BETWEEN S CORP VERSUS C CORP

The TCJA brought about a myriad of changes to C Corp and S Corp tax rules. Over the past 40 years, tax practitioners have seen the effective corporate tax rates increase relative to personal income tax rates. The TCJA brought a significant reduction of the federal corporate tax rate and not quite the same reductions in personal tax rates. It is easy to see why a corporate tax structure is a much easier tax pill to swallow and may be the most tax efficient entity type if a large portion of earnings are not being distributed to owners but are being retained in the company for growth and / or debt repayment.

- Highest effective tax rates of S-Corp net income – 37% (29.6% with full section 199A deduction)
- Highest effective tax rates of C-Corp net income – 21% (plus 15% or 23.8% on dividend distributions)

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

Considerations to keep in mind for converting from an S-Corp to a C-Corp:

- Is Entity/Owners eligible for QBI Deduction?
- If change from S to C, how are historical earnings taxed leaving a C-Corp
- Per 1371(e)(1) during the post-termination transition period (PTTP) the corporation is allowed distributions tax free to the extent of AAA. These distributions decrease the owner's basis in the stock. Note – lack of clarity what happens to unused AAA if re-elect S status down the road.
- After PTTP closes distributions are treated as pro-rata coming from AAA and E&P for an eligible S-Corp (same ownership proportions as S-Corp when C-Corp)
- PTTP generally ends on later of one year after S-election revocation or due date for filing the final S-Corp return including extensions.
- Plan for Future Cash Distributions to Owners (beware, second layer of tax)
- Future Plan to exit the business (beware, second layer of tax)
- Must remain C-Corp for five tax years.
- Must Consider B.I.G. consequences for 5 years post re-electing S-Corp status

## Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

Below is a chart comparing the pre and post TCJA impact of an S- and C-Corporation:

	S-Corporation		C-Corporation	
	Pre Tax Law	Post Tax Law	Pre Tax Law	Post Tax Law
Qualified Business Income	\$ 1,500,000	\$ 1,500,000	\$ 1,500,000	\$ 1,500,000
DPAD	9.0%	(135,000)	(135,000)	
199A Deduction	20.0%	(300,000)		
Net Taxable Income	\$ 1,365,000	\$ 1,200,000	\$ 1,365,000	\$ 1,500,000
Tax Rates	39.6%	37.0%	34.0%	21.0%
Tax Expense	\$ 540,540	\$ 444,000	\$ 464,100	\$ 315,000
Tax on Distribution of Income / Dividend			\$ 207,180	\$ 237,000
Total Tax	\$ 540,540	\$ 444,000	\$ 671,280	\$ 552,000
Effective Tax Rate	36.0%	29.6%	44.8%	36.8%

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## TAX PLANNING TIPS AROUND NET OPERATING LOSSES, BONUS DEPRECIATION, AND SECTION 179

### NOL CHANGES

The Tax Cuts and Jobs Act significantly changed the way NOLs generated in 2018 and beyond are treated. First, NOLs generated in 2017 or prior still continue to follow the old rules, carry back period of two years and/or carry forward for 20 years. NOLs generated in 2018 are only able to be carried forward indefinitely. Also, NOLs can only offset 80% of taxable income. This significantly decreases the value of the NOL tax assets.

#### Use of Net Operating Losses - CARES Act

**Net Operating Losses subject to a 5-year carryback and not limited by 80% of Taxable Income Rule. This applies to NOLs from 2018, 2019 or 2020.**

### BONUS DEPRECIATION CHANGES

The TCJA brought some major changes to the treatment of bonus depreciation. First, the bonus depreciation amount increased from 50% to 100% acquired after September 27, 2017 through 2022 and will phase down to zero over a 5 year period after that. Secondly, the TCJA removed the requirement that the original use of qualified property must commence with the taxpayer. In other words, new AND used assets are eligible for bonus depreciation.

On September 21, 2020 the IRS issued final regulations for bonus depreciation under Sec. 168(k). The final regulations provide guidance for partnerships, consolidated groups, and taxpayers that undertake a series of related transactions. The final regulations differ significantly from the proposed regulations issued in September 2019. Review the final regulations for potential favorable changes and weigh the benefits of adopting the final regulations rather than the 2019 proposed regulations for tax years ending before January 1, 2020.

#### **Bonus Depreciation is Allowed on Qualified Improvement Property (QIP) costs under The CARES Act.**

The legislative error in the TCJA is fixed and QIP now is eligible for immediate write-off. This provision is retroactive.

### SECTION 179 CHANGES

The TCJA did not make major changes to Section 179 depreciation. Section 179 is still allowed on both new and used property. The maximum deduction increased from \$500,000 to \$1,000,000 (indexed for inflation). Plus, the phase-out threshold increased from \$2,000,000 to \$2,500,000 (indexed for inflation). At

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

\$2,500,000 of purchased Section 179 starts to phase out dollar for dollar and is fully phased out at \$3,500,000. The maximum deduction is \$1,020,000 and the deduction begins to phase out at \$2,550,000 for 2019 through 2022.

## TAX PLANNING TIPS

Since Congress heavily expanded the use of bonus depreciation, we foresee many taxpayers having a very high tax depreciation expense in 2018 and beyond. In many circumstances, the use of bonus depreciation will likely cause a taxable loss, therefore generating a net operating loss. Since NOLs can no longer be carried-back and can only offset 80% of future taxable income. We recommend using Section 179 as a tool to limit the NOL generation and generate a section 179 expense carry forward. Section 179 expense carry forward will offset future taxable income dollar for dollar, while the NOL may only offset 80% of taxable income.

## IRS Notice 2020-75: Deductibility of State and Local Taxes

IRS provides certainty regarding the deductibility of payments by partnerships and S corporations for State and local income tax.

- Specifically, the proposed regulations will clarify that State and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment, and therefore are not subject to the State and local tax deduction limitation for partners and shareholders who itemize deductions.
- The notice describing the forthcoming proposed regulations applies to these types of income taxes starting November 9, 2020, and also allows taxpayers to apply these rules to specified income tax payments made in a taxable year of a partnership or an S corporation ending after Dec. 31, 2017, and before the date the forthcoming proposed regulations are published in the Federal Register.
- This notice assures an entity level deduction for Contractors that pay entity level state and local taxes imposed in lieu of individual income taxes or offset by credits on the individual partner or shareholders returns.
- To date, seven states (Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island and Wisconsin) have enacted some type of entity level tax where application of this IRS notice may apply. Contractors that are currently filing in these states should evaluate these new state filing requirements and be on the look-out for additional states to pass their own legislation to allow an entity level tax deduction.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## Comparison of M&E Expense Under the Old Law Versus the New Law

Event	2017 Expenses (Old Rules)	2018 Expenses (New Rules)*
Office Holiday Party or Summer Picnic	100% deductible	100% deductible
Client Business Meals	50% deductible if taxpayer is present, and not lavish or extravagant.	50% deductible if business is conducted, taxpayer is present, and not lavish or extravagant.
Entertainment-related Meals	50% deductible.	No deduction (e.g., meals incurred when no business is conducted, potentially at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation, and similar trips).
Transportation to/from Restaurant for Client Business Meal	100% deductible.	100% deductible.
Sporting Event Tickets	50% deductible for face value of ticket. 50% deductible for skybox expenses to the extent of non-luxury seat ticket face value in such box. 100% deductible for charitable sporting events. Contributions for the right to purchase tickets to an educational institution's athletic events 80% deductible. 50% for transportation to/from and parking at the sporting events.	No deduction. No deduction. No deduction. No deduction. No deduction.

## Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

Event	2017 Expenses (Old Rules)	2018 Expenses (New Rules)*
Club Memberships	No deduction for club dues; however, 50% deduction for expenses incurred at a club organized for business, pleasure, recreation or other social purposes if related to an active trade or business.	No deduction.
Meals Provided for the Convenience of Employer	100% deductible provided they are excludable from employee's gross income as de minimis fringe benefits; otherwise 50% deductible.	50% deductible (non-deductible after 2025)
Meals Provided to Employees Occasionally and Overtime Employee Meals	100% deductible provided they are excludable from employees' gross income as de minimis fringe benefits; otherwise 50% deductible.	50% deductible.
Water, Coffee, and Snacks at the Office	100% deductible provided they are excludable from employees' gross income as de minimis fringe benefits; otherwise 50% deductible.	50% deductible (non-deductible after 2025)
Meals in the Office During Meetings of Employees, Stockholders, Agents, or Directors	50% deductible.	50% deductible.
Meals during Business Travel	50% deductible.	50% deductible.
Meals at a Seminar or Conference, or at a Business League Event	50% deductible.	50% deductible.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

Event	2017 Expenses (Old Rules)	2018 Expenses (New Rules)*
Meals included in Charitable Sports Package	100% deductible.	50% deductible.
Meals Included as Taxable Compensation to Employee or Independent Contractor	100% deductible.	100% deductible.
Meals Expenses Sold to a Client or Customer (or Reimbursed)	100% deductible.	100% deductible.
Food Offered to the Public for Free	100% deductible.	100% deductible.

\*On September 30, 2020, the IRS issued final regulations on the business expense deduction for meals and entertainment under Sec. 274. The final regulations address the disallowance of the deduction for expenditures related to entertainment, amusement or recreation activities. The final regulations also provide guidance to determine whether an activity is considered entertainment as well as the limitation on the deduction of food and beverage expenses. The final regulations are effective for tax years beginning on or after October 9, 2020 so taxpayers can continue to rely on the proposed regulations for tax years beginning prior to October 9, 2020.



# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

## OPPORTUNITY ZONES

The Opportunity Zone Program is an effort by the Federal Government to spur new or increased investments in low-income communities. It is based on 25% of the census tracts identified as 'Low Income Communities' by the Community Development Financial Institutions Fund (CDFI Fund), a division of the US Department of the Treasury.

The program offers a tax incentive for investors by allowing them to contribute their capital gains within 180 days of the sale into Opportunity Funds. Under the program, if a capital gain is invested in a Qualified Opportunity Fund within 180 days of realizing the gain, then the gain is not included in income until the investment is sold, or December 31, 2026, whichever is sooner. There are three potential separate tax benefits – (1) temporary deferral, (2) permanent exclusion of either 10% or 15%, or (3) permanent exclusion of post-acquisition appreciation.

The investor can contribute their capital gain in a Qualified Opportunity Fund within 180 days of the sale, then the tax due on the gain can be deferred for as long as eight years, decreasing the gain by up to 15% and escaping tax on future appreciation if held at least 10 years. There are roughly 8,700 opportunity zones throughout the United States.

### Requirements:

- Must be certified by the US Treasury Department
- Must be organized as a corporation or partnership for the purpose of investing in Qualified Opportunity Zone Property.
- Must hold at least 90% of their assets in Qualified Opportunity Zone Property
- Qualified Opportunity Zone property includes newly issued stock, partnership interests, or business property in a Qualified Opportunity Zone business.
- Opportunity Fund investments are limited to equity investments in businesses, real estate, and business assets that are located in a Qualified Opportunity Zone.
- Loans are not eligible for the tax incentives.
- Opportunity Fund investments are subject to a substantial rehabilitation requirement.

# Tax Planning Opportunities for the Construction Industry

Prepared by: CICPAC | CPAs who know Construction

**We could not produce our timely resources without the generous support of our sponsors!**

**Premier Sponsor:**



Since 1985, Foundation Software - creators of FOUNDATION® job cost accounting and project management software and mobile tools - has been a trusted name for both contractors and construction-focused CPAs. Part of that trust comes from our philosophy to always strive for improvement. We never outsource; sales, support and all development happens in-house, allowing us to deliver best-of-breed products and services to contractors. Founder Fred Ode started this vision, and today we proudly serve over 6,000 successful construction companies and employ nearly 400 professionals dedicated to serving these clients. With our culture and commitment to constantly improve, we're a partner for the long-haul. It's what's powered us forward for the past 35+ years, and it's what'll keep us moving for years to come.

Learn more at <http://www.foundationsoft.com/for-cpas/>

**Supporter Sponsor:**



A payroll service just for construction, Payroll4Construction.com can handle all the complexities of the construction industry, like multi-state, multi-rate pay on a single timecard. With the mobile timecard app, employees can clock-in and clock-out, supervisors can approve hours, and data can be synced right to the service, eliminating the need to enter information twice. And once payroll is complete, contractors and their CPAs can download instantly updated financial reports – from certified payroll and job costing to new hire and workers' compensation, and more. Contractors save time, and their CPAs can rest easy knowing they've got up-to-date and accurate data.

Learn more at [www.payroll4construction.com](http://www.payroll4construction.com)