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Construction Accounting: The Eternal Conflict Between Taxes and Bonding

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Construction Accounting: The Eternal Conflict Between Taxes and Bonding

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I. Overview.

A construction company is a unique type of business because there is no steady or long-term repetitive revenue source. This can lead to wild swings in revenue and profitability from one year to the next. The financial statement presentation is critical for a construction contractor because this is the main foundation his banking and bonding relationships are built upon. Therefore, it is important for a construction company owner to understand his financial statements and tax returns.

This presentation's goal is to help the contractor understand why his bonding and banking needs are sometimes inversely related to his tax planning goals, explain the differences between a contractor's tax returns and his financial statements, and offer examples of tax planning items that do not adversely affect bonding and banking, and finally, give contractors an update on the recent changes to the tax laws that affect them.

a. Caveat.

No tax planning or financial statement presentation can fit all individual situations. Each plan should be developed and implemented depending on the facts of each particular contractor. In addition, the tax laws are changing with ever increasing frequency. Therefore, you must consult your legal and tax advisor to assist you in implementing any of these strategies.

II. Why do a Contractor's Financial Statement and Tax Return look so different?

When reviewing year end financial statements and tax returns, I have had many contractors scratch their heads wondering how their financial statements could show one income amount and their tax return could show a substantially different amount. The reason for this is the IRS allows different methods of accounting for tax purposes as opposed to the only method allowed for financial statement purposes: GAAP.

a. What are GAAP Basis Financial Statements?

GAAP means the Generally Accepted Accounting Principles that most all CPAs follow when preparing a financial statement for a contractor. These should include detailed footnotes; break out of accounts receivable aging; and job schedules that disclose the project revenues, costs, and gross profits by accounting period. Typically, CPAs who have a construction focus are more knowledgeable and better advisors to a construction contractor.

The goal of GAAP financial statements is to accurately communicate to the contractor his actual financial position: what his working capital (liquidity) is; what his equity (assets minus liabilities) is; and often most importantly, what the contractor made or lost during the past year. Accurately recording checks, deposits, billings, and invoices is a factor in preparing accurate financial statements. However, for a contractor, there is a surprisingly large reliance on estimates.

One such estimate that is important to almost every contractor is the estimated profit on jobs in progress. This calculation matches the billings with the costs over any given accounting period. Without accurately determining this, a contractor's financials will wildly swing from one month to the next. Changing these estimates can have a significant impact on GAAP basis financials.

Another estimate that is especially critical for an equipment intensive contractor, such as an excavator, is depreciation. The goal under GAAP should be to accurately estimate the devaluation of a piece of equipment over any given year. This is done by estimating the useful life of the asset, its salvage value at the end of that life, and then taking the purchase price and reducing its value to the salvage amount over the term of that life.

With GAAP basis financials, the goal of the CPA is to accurately report to the owner his true financial position.

b. What methods of accounting are available for a Construction Contractor for tax purposes?

While all contractors are required to use the GAAP basis of accounting for financial statement purposes, there are many options for contractors for income tax purposes. They are cash basis, accrual basis, completed contract basis, and percentage of completion basis. Each of these methods calculate income based on the accumulation of certain assets and excluding others.

The cash basis, as its name implies, calculates income based on the accumulation of cash over the previous twelve-month period. Therefore, under the cash basis, accounts receivable, retainage, work in progress, and prepaid assets are not considered to be a part of income for tax purposes. Because of the nonrecognition of so many assets, it is common for a contractor to show a significant income for financial statement purposes while possibly showing a loss for tax purposes. For this reason, the cash basis is a very attractive method for those contractors who qualify to use it.

To qualify for use of the cash method, the contractor cannot maintain significant inventory, cannot average more than $10,000,000 in gross revenues for the past three years, and the use of the cash method cannot significantly distort income. (The gross revenue limit is $5,000,000 for C-Corporations or partnerships with a C-Corporation partner.) There is a safe harbor rule for contractors who gross under $1,000,000; they can use the cash method regardless of maintaining inventories. If a contractor qualifies for the cash method, in almost all situations, it will result in lower taxes than other methods.

For contractors who do not qualify for the cash basis, usually their next best alternative is either the accrual method or the completed contract method. To determine which of these options is better, the individual circumstances and industry of the particular contractor must be analyzed.

The accrual method taxes the net increase in cash, accounts receivable, and other types of prepaid assets to calculate taxable income. This method excludes retainage and deficit billings. Like the cash method, excluding the accumulation of retainage and deficit billings can result in a situation where the contractor is able to show significant income for financial statement purposes while minimizing taxable income.

The completed contract method taxes job profits only upon completion of the project. Thus all work in progress, including all billings and expenses, are excluded from taxable income. This method is generally preferable to the accrual method for contractors who do not carry large retainage balances.

Percentage of completion method of accounting is the same method of accounting that is generally required to be used for financial statement purposes. All increases in net assets are included in the calculation of income for tax purposes. Because this method of accounting does not exclude any type of asset, contractors generally do not use it for tax purposes if they have a choice. The percentage of completion method of accounting is required for contractors who gross in excess of $10,000,000 for a three-year average or whose contracts exceed two years.

With income tax accounting, the goal of the CPA is to utilize all the tools available to minimize the contractor's recognition of income. As a result, the income reported on the tax return does not accurately reflect the actual earnings of the contractor - nor should it.

c. Why does one tax savings device hurt a contractor's bonding while another does not?

Because a contractor's bonding is primarily based on the condition of his financial statements, it is critical for a contractor not to take steps for the sake of tax savings that hurt his financial statements. There are alternatives available that save income taxes, but do not adversely affect a contractor's ability to bond or obtain financing.

Examples of these tax savings steps that adversely affect the financial statement are as follows: spending down cash at year end, paying large bonuses, contributing to retirement plans, making donations, purchasing unnecessary or excess supplies, making repairs before they are needed, or otherwise consuming working capital for the sake of saving taxes. While the idea of doing these types of things can be suspect, as many times the contractor is spending a dollar to save thirty cents, the residual effect of reduced bonding capacity and therefore lost revenue can cost the contractor far more than any tax savings realized.

When attempting to manage his tax burden the contractor must utilize areas of accounting that are allowed departures between GAAP and income tax accounting. That way, when the contractor takes advantage of an income tax incentive, it does not adversely affect his financials because these are allowed differences in accounting.   Examples of these are utilizing the different methods of accounting mentioned above along with utilizing the accelerated methods of depreciation for equipment and the new tax incentives such as the domestic activities production deduction and the research and development credit.

By utilizing items which are not recorded on a contractor's financial statements but are authorized to be recorded on his tax returns, the contractor is able to gain the tax deductions while also preserving his financial statement bonding and financing power.

III. What tax savings devices are there for a construction contractor that will not hurt its bonding?

Many contractors believe the only way they can save income taxes is by taking steps that hurt their financial statements and therefore diminish their bonding capacity and financing. This is untrue. There are tax savings opportunities available that are allowed departures between the financial statements and tax returns. Examples of those are the allowed different methods of accounting mentioned above, the differences in depreciation for book and tax purposes, section 179 expense deduction, bonus depreciation, the domestic activities production deduction, and the research and development credit.

a. Allowed alternative methods of accounting for income.

The differences between allowed accounting methods can be a significant source of tax savings. The use of the cash, accrual, or completed contract method of accounting creates opportunities for the contractor to plan and manage his taxable income. If a contractor qualifies for these methods, he should certainly do so. However, in recent years, the rise of the alternative minimum tax has diminished the tax benefits of these alternative methods for calculating income. Therefore, it has increasingly become important to find methods that are exempt from AMT.

b. Section 179 expense election.

One such tax savings method that is exempt from AMT is the Section 179 deduction. Section 179 expense deduction is an equipment investment incentive provided by Congress to stimulate small businesses to invest in equipment. This rule allows a contractor to immediately deduct the first $500,000 (years 2010 and 2011) worth of new or used equipment purchased in the year of purchase rather than depreciating it over several years. The 179 deduction is scheduled to fall to $125,000 starting in 2012, and $25,000 thereafter, however this provision is routinely adjusted by Congress shortly before the reduction takes effect. This deduction applies regardless of whether cash or debt is used to pay for the asset. On December 31st, a contractor may simply sign a note for a new piece of equipment and immediately create an additional $500,000 of expense deductions for his company.

These expense limits are increased by $100,000 if the property is qualified disaster assistance property.

There are a few limitations for use of this rule. This rule applies only to contractors who purchase less than $2,000,000 (years 2010 and 2011; $500,000 in 2012 and $200,000 thereafter) in equipment per year. The deduction cannot create a tax loss for the contractor. If there is no income, the deduction will be carried forward until there is sufficient income to utilize the full loss. Additionally, the equipment purchased must meet certain qualifications. Generally, all construction equipment, new or used, will qualify.

c. Expensing of real estate improvements.

An expansion of the definition of equipment that qualifies for section 179 was passed on 27 September 2010. For the years 2010 and 2011, Section 179 equipment now includes leasehold improvements, retail improvements, and restaurant property. However, no more than $250,000 of the total section 179 expense can be attributable to real property.

Qualified leasehold improvements include any improvement made by a lessor or lessee to the interior of a building pursuant to a lease. Exceptions provide that the improvement must be made more than three years after the building was placed in service, the improvement did not enlarge the structure, was not an elevator or escalator, and was not an improvement to a structural component of a common area or the building.

d. Vehicle depreciation.

For vehicles, there are a myriad of new rules. Normally, vehicles are subject to tight depreciation deduction rules that make them very unattractive as a tax deduction. Generally, a car placed in service during 2010 is limited to $11,060 for its first year's depreciation. A nonqualifying truck or van is limited to $11,160.

However, trucks (including pickup trucks) and vans that have a loaded gross vehicle weight over 6,000 pounds are eligible for the full $500,000 section 179 depreciation deduction. Also exempt from the vehicle depreciation limitations are vehicles that have been specially modified in such a way that they are not likely to be used for personal purposes. Examples of this are a van with shelves in the back or a small truck fitted with pest control systems.

Sport utility vehicles and trucks with less than a six foot bed are limited to a section 179 deduction of $25,000.

e. Section 199 Domestic Production Activities Deduction.

This code section allows for a deduction of 9% of the income derived from exchanges of property manufactured or produced in the United States. Along with manufacturers, this deduction applies to contractors, architects, and engineers. Therefore, a construction contractor can take as a deduction 9% of its taxable income under this code section.

This deduction has grown over the years, starting at 3% of net income during 2005 to 2006; 6% for 2007 to 2009; and 9% thereafter. Because this deduction was originally targeted toward manufacturers, many CPAs have not realized that this applies to construction contractors. For a high percent of our new clients, we find that this deduction was not taken, and we generate immediate cash flow for the contractor by amending their prior returns to take advantage of this code section.

This deduction is calculated based on a contractor's net income. So if the contractor had a loss in any given year, then no deduction. This deduction is also limited to 50% of the contractor's W-2 wages. So if a contractor has minimal labor costs, this deduction will be limited.

f. Bonus depreciation.

Bonus depreciation allows a contractor to deduct 50% of the total cost of equipment placed in service 2008 to 2012. In addition, property placed in service September 9, 2010 to December 31, 2011, qualifies for 100% deduction.

Most all equipment will qualify for this deduction, but unlike Section 179 above, the property must be new. Leasehold improvements also qualify for this deduction.

Also unlike Section 179, there is no income limitation for this deduction. Therefore, this deduction can create a loss which may be carried back to prior years to recover taxes already paid. Bonus depreciation is allowed in full for AMT purposes, so taking this deduction will not create an AMT tax problem.

g. Capital gain exclusion from the sale of small business stock.

A contractor can exclude 50% of any gain from the sale of small business stock held for more than five years. This exclusion rises to 60% if the corporation is in an empowerment zone. It's 75% if the stock was acquired after February 17, 2009, and before September 28, 2010. It's 100% if the stock was acquired after September 27, 2010 and before January 1, 2012.

This exclusion is subject to an overall limit of the greater of $10,000,000 or 10 times the basis in the stock.

To be eligible, the stock must have been received at its first issue to the taxpayer after August 10, 1993, and the underlying company cannot have more than $50,000,000 in assets.

Alternatively, the contractor may exclude all of his gain by rolling over the small business stock into the purchase of another qualified small business stock within 60 days from the date of the original sale.

Seven percent of this exclusion is included in income for AMT purposes, unless it was stock acquired after September 27, 2010 and before January 1, 2012, which carries no AMT adjustment.

IV. What's new this year that might affect construction contractors?

a. Tax rates stay the same.

Federal tax rates were scheduled to revert back to 15, 28, 31, 36, and 39.6 at the end of 2010. The current rates of 10, 15, 28, 33, and 35 will remain in place until the end of 2012.

b. Estate taxes are reinstated.

Unbelievably, there was no estate tax for 2010. The rate for 2011 was set to fall back to $1,000,000; however, Congress updated this to set a 35% tax on estates over $5,000,000. In addition, this $5,000,000 exemption is now portable between spouses, so a surviving spouse could have a $10,000,000 total exemption.

c. Capital gains and dividend rates.

Capital gains and dividends remain at a rate of 15% through 2012. This rate is 0% for taxpayers with under $69,000 in income. This is a planning opportunity that could be combined with some of the equipment deductions mentioned above.

d. Itemized deduction and personal exemption phaseouts.

Formerly, taxpayers who made over approximately $250,000 lost some or all of their personal exemptions and itemized deductions. There is no phaseout in effect through 2012.

e. Payroll tax cut.

The employee share of SSI is cut from 6.2% to 4.2% through 2011. These rates apply to wages up to $106,800. There was no cut in the employer match.

f. The research and development tax credit.

This credit is somewhat convoluted to explain, but is essentially 14% of the amount spent on research and development. This could be applicable to a contractor particularly with the emerging green construction methods.

g. Work opportunity tax credit.

This credit amounts to 40% of the first $6,000 paid to a new hire from a targeted group through the end of 2012. This credit jumps to 40% of the first $12,000 for a service disabled veteran.

The targeted group includes new hires who meet one of the following classifications: aid to families with dependent children recipient; unemployed veterans; ex-felons within one year of release; an 18 to 39 year old residing in an empowerment zone (Pulaski County has a large empowerment zone), renewal community, or rural renewal county; food stamp recipients under 40; qualified summer youth employees (16 to 17 year olds); SSI recipients; or long-term family assistance recipients. The employer must apply to get these new hires certified within the first 28 days of employment.

h. New energy efficient home credit.

Homebuilders may qualify for a $2,000 credit per home they build and sell through the end of 2011. This includes remodeling. To meet this test, the home must be certified to be 50% more energy efficient than other comparable dwellings and 1/5 of this efficiency must come from the building envelope. The certification must be in writing, must specify the envelope components and H & A equipment installed, and their rated energy performance.

i. Energy efficient appliance credit.

This offers various small credits, up to $250, for purchasing energy efficient appliances. This could be especially lucrative for apartment builders.