

New Tax Laws and Tax Savings Tips for Construction Contractors

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J. Richard Newland, Jr., J.D., C.P.A.
Ferguson, Cobb & Associates, PLLC
#10 Corporate Hill, Suite 330
Little Rock, AR 72205
(501) 221-3800

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- A. General overview of how contractors are taxed.
- B. What are the different bases of accounting available to construction contractors and how does this save in taxes?
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(The following explanation of the tax system applicable to contractors has been oversimplified and is intended only for a general discussion.)

- A. General overview of how contractors are taxed.

Construction contractors are taxed on the amount that net assets (less liabilities) increased from the same period 12 months prior. This is different from what most contractors think of when being taxed which is "income." However, the tax code allows income to be defined numerous different ways - some of which can be used to the advantage of a growing contractor.

- B. What are the different bases of accounting available to construction contractors and how does this save in taxes?

There are numerous bases of accounting (or different definitions of income) allowed for construction contractors. 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 and to show a loss for tax purposes. For this reason, the cash basis is a very attractive method for those contractors that can 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 this 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 work in progress 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. Thus, it is very difficult to have a year where the taxable income is much lower than the income shown on the financial statements. 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.

C. Other tax tips for construction contractors.

Construction contracting is a very equipment intensive business. There are a couple of rules relating to the depreciation of equipment that contractors generally can use to their advantage.

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 \$102,000 (year 2004) worth of new or used equipment purchased in the year of purchase rather than depreciating it over several years. This 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 \$102,000 of expense deductions for his company.

There are a few limitations for use of this rule. This rule applies only to contractors who purchase less than \$410,000 (year 2004) 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 will qualify.

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. However, trucks (including pickup trucks) and vans that have a gross vehicle weight over 6,000 pounds are eligible for the full \$102,000 depreciation deduction. Sport Utility Vehicles placed in service after Oct 22, 2004, are limited to \$25,000. Also exempt from the vehicle depreciation

limitations are trucks and vans less than the 6000 gross vehicle weight that have been specially modified in such a way that they are not likely to be used for personal purposes. Hybrid vehicles qualify for a \$2,000 tax credit.

For contractors who have heavy machinery, such as excavators, asphalt pavers, etc., **the timing of repairs** can result in tax savings. If the contractor is having a high tax year, one in which the contractor may be paying higher tax rates such as 35%, the contractor should look to replace worn out parts, and undertake other repairs during that year. The tax savings could cut the “real” repairs expense by a third.

The most important thing when considering any type of tax savings strategy is the potential impact on the contractor’s financial statements and the related ability to obtain bonding. Most of the savings tips mentioned in this presentation, if managed correctly, will not have a significantly negative affect on the contractor’s financial statements. The contractor will be best served when there is an adequate emphasis placed on protecting the bonding program and the CPA works closely with the surety agent.

D. What’s new this year that might affect construction contractors?

- Manufacturing Deduction §199 – There is a new deduction available for contractors that allows the contractor to deduct a certain percentage of net income made from construction activities. This deduction is 3% of net income derived from construction during 2005 to 2006; 6% for

2007 to 2009; and 9% thereafter. This deduction is limited to 50% of the taxpayers W-2 wages and qualified deferred compensation.

- The exemption for the estate tax has changed, but it is a hollow change. In 2003, the estate tax exemption was \$1,500,000. In 2006 the exemption rises to \$2,000,000. In 2009, the exemption rises to \$3,500,000. There is no estate tax for 2010. And the exemption drops to \$1,000,000 starting in 2011.
- Personal residence exclusion has increased to \$500,000 for the sale of a personal residence previously occupied for not less than 2 years.
- *Hospital Corp. of America, 109 TC 21*. This case recently stated that not all components of a building must be depreciated over the usual 39 years allowed by the IRS. Instead, certain components of the building may be depreciated using much shorter lives such as 7, 10, and 15 years. Examples of items that may, under certain circumstances, be depreciable under faster methods are as follows:
 - carpeting
 - awnings or similar
 - blinds, shades, shutters, drapery
 - security lighting, battery powered lighting
 - standby generators along with fuel tanks, lines, alternator and controls
 - detachable fire detection and security systems
 - exterior lighting, landscape/decorative/accent lighting

exterior ornamentation, landscaping

detailed crown molding, ornate wall paneling

movable partitions or walls

plumbing for cafeteria equipment

signs

curbs, sidewalks, driveways, roads, parking lots, drainage facilities

playground equipment

fencing