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MAXIMIZING YOUR TAX SAVINGS: YEAR-END PLANNING TIPS FOR CONSTRUCTION CONTRACTORS

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Jim Lundy is a partner in the Tax & Business Services division at Marcum LLP and a member of Marcum's national Construction Industry Practice group. With more than 30 years of experience in both public and private practice, Mr. Lundy is one of the most respected tax consultants in the construction industry. He works regularly with more than 350 construction entities to provide a wide range of tax services. Services include performing tax physicals to provide a full overview of a construction company's tax compliance and planning opportunities, establishing continuity and succession plans for contractors, dealing with federal and state authorities regarding tax issues important to contractors and leading in the timely completion of tax reporting required for the construction industry.

Mr. Lundy is an accomplished speaker and the author of many articles published on construction tax-related issues. The Tennessee Society of CPAs has honored him as Speaker of the Year more than 10 times; the Alabama Society of CPAs has presented him with their Thomas A. Ratcliff Outstanding Discussion Leader Award; and he has been the highest-rated speaker at both the American Institute of CPAs' National Construction Industry Conference and the AICPA National Tax Conference. He is often sought out to provide in-house training to other CPA firms and organizations interested in obtaining the most up-to-date and practical applications of the tax rules and regulations pertaining to the construction industry. He has also testified before the Tennessee Tax Commission regarding the taxation of multi-state contractors.

Mr. Lundy is a past chair of the TSCPA Construction Committee and is former chairman of the AICPA National Construction Committee. He helped direct the very successful initial statewide construction conference and has been active in other committees, including the Continuing Education Committee, the Accounting Careers Committee, the Tennessee Road Builders Investment Committee and the Board of Directors of the Middle Tennessee Associated Builders and Contractors.

Jim is licensed as a Certified Public Accountant in the states of Tennessee, Florida, South Carolina, and Oregon. He graduated from Lipscomb University with a Bachelor of Science degree in accounting.

1. Research and Development Costs

- Under current law, R&D costs (Section 174) incurred after 12/31/21 must be capitalized and amortized over 5 years (15-years for foreign activities.)
  - Costs can be difficult to identify for contractors.
  - H.R. 3938 – “Built It in America Act” would allow expensing for Section 174 costs through December 31, 2025. For amounts paid or incurred in taxable years beginning after 12/31/25, the costs would be amortized over 60 months.
    - Introduced June 13, 2023
    - Likelihood of passing is unknown at this time
      - To be discussed after August recess

1. Research and Development Costs (continued)

- Option 1 – Code Section 460 overrides Code Section 174.
  - Requires costs incurred to be used to calculate percentage of completion
  - Similar results to pre 2022 tax POC
  - Disclosure and Form 8275 included with return

1. Research and Development Costs (continued)

- Option 2 - Assuming Taxpayer uses the Regular Cost Allocation Method required under IRC §460(c), R&D costs are an allocable job cost per both 460 and the Regs. Per 1.460-5(f), costs do not include nondeductible items. The R&D amortization is deductible but over 6 years because of HY convention.
  - The total costs at completion includes the total R&D amount (denominator).
  - The 90% future amortization in year 1 is excluded from costs incurred to date (numerator) and because the full R&D is included in the total estimated cost, the capitalized 174 costs reduces percent complete and profit recognition.
  - Each subsequent year 20% of the R&D is charged to job costs.
  - IRS Notice 2022-63 (Interim Guidance) issued 9/8/2023

1. Research and Development Costs (continued)

- Reg. §1.460-1(c)(3) – A Taxpayer's contract is completed upon the earlier of:
  - Use of the subject matter of the contract by the customer for its intended purpose and at least 95% of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or
  - Final completion and acceptance of the subject matter of the contract.

- According to Reg. §1.460-4(b)(3) - Taxpayer must include in gross income, for the tax year immediately after the completion year, any previously unreported portion of the total contract price (including amounts that the taxpayer expects to receive in the future) determined as of that year.

2. Failure to Utilize Section 179D Deduction

- Pre-IRA deduction: Energy efficient commercial building deduction of $1.80 per square foot (adjusted for inflation: $1.82/SF in 2021, $1.88/SF in 2022)
- Available for newly constructed buildings or building improvements placed in-service after January 1, 2006
- Energy performance must be modeled by a qualified third party and certified by a contractor or professional engineer licensed in the state where the building is located
- Pre-IRA, Section 179D deduction can be claimed by:

Owners and tenants of commercial buildings who've built or installed improvements

Owners of four-story or greater residential buildings who've built or installed the improvements

Designers of government-owned, energy-efficient buildings (architects, engineers, or contractors)

2. Failure to Utilize Section 179D Deduction (continued)

Pre-IRA Law: January 1, 2006 to December 31, 2022

- Commercial building owners
- Designers of buildings owned by government entities

IRA Update: Beginning January 1, 2023 (Technically January 30…)

- Commercial building owners
- REITs
- Designers of buildings owned by:
  - Government entities
  - Not-for-profit organizations
  - Churches and other religious organizations
  - Tribal organizations
  - Not-for-profit schools and universities

2. Failure to Utilize Section 179D Deduction (continued)

Pre-IRA Law: January 1, 2006 to December 31, 2022

- $0.60/square foot for each of 3 eligible systems (HVAC and hot water, Interior Lighting, and Building Envelope)
- $1.80/square foot maximum if energy savings is 50% or greater
- Adjusted for inflation
  - 2021: $0.61/system to $1.82 max
  - 2022: $0.63/system to $1.88 max

IRA Update: Beginning January 1, 2023

- **Base deduction:** Sliding scale of $0.50/square foot for energy savings of 25% and up to $1.00/ square foot for energy savings of 50% or greater
- **Bonus deduction (<u>prevailing wage & apprenticeship</u>):** Sliding scale of $2.50/square foot for energy savings of 25% and up to $5.00/ square foot for energy savings of 50% or greater
- **<u>If construction began prior to January 30, 2023</u>**, the project is deemed to meet the prevailing wage and apprenticeship requirements for the increased “bonus” amounts for 179D

2. Failure to Utilize Section 179D Deduction (continued)

- Maximum deductions based on building size

BUILDING EXAMPLES	BUILDING SIZE IN SQUARE FEET	PRE-IRA DEDUCTION MAXIMUM (JAN 1, 2006 – DEC 31, 2022)	POST-IRA DEDUCTION MAXIMUM* (JAN 1, 2023 – ONGOING)	WITHOUT PREVAILING WAGE
OFFICE / ELEMENTARY SCHOOL	50,000	$90,000	$250,000	$25,000 - $50,000
HIGH SCHOOL / MULTISTORY RESIDENTIAL	100,000	$180,000	$500,000	$50,000 - $100,000
HOSPITAL / WAREHOUSE	500,000	$900,000	$2,500,000	$250,000 - $500,000

3. Employee Retention Credits

- Refundable payroll tax credit for businesses who meet either of the two below:
  - Qualified gross receipts reduction
    - 50% when comparing a 2020 quarter to the same quarter in 2019
    - 20% when comparing a 2021 quarter to the same quarter in 2019
  - Partial suspension of business operations mandated under a US government order
    - Not straight forward and requires a thorough analysis to establish a reasonable position
    - IRS has issued guidelines for “supply chain disruption”

3. Employee Retention Credits (continued)

- Third-Party Concerns:
  - IRS has issued guidance to warn taxpayers against the risk of using third parties who are not doing the due diligence to verify taxpayer qualification.
  - Contractors should be warned against third parties charging contingent fees, engagement letters stating the taxpayer determined qualification, ERC letters that look like IRS Notices that cause the taxpayer to provide personally identifiable information that is being used to scam and conduct identity theft.
  - ERC has been added to the IRS' Dirty Dozen list.
  - IRS has paused review of new claims through 12/31/23
    - 900,000 refunds outstanding

3. Employee Retention Credits (continued)

- Important Considerations:
  - Wage deduction disallowance on the federal income tax return(s) for the amount of credit in the year the employer is qualified
  - Some states conform to the federal deduction disallowance under IRC 280C when calculating the state's taxable income for corporations

3. Employee Retention Credits (continued)

- Timing to Claim The Credit/IRS Reviews
  - Statute of limitations for filing amendments to claim these credits
    - 2020 deadline = 4/15/2024
    - 2021 deadline = 4/15/2025
  - Statute of limitations for IRS assessment
    - 2020 Q2 through 2021 Q2 = 3 years
    - 2021 Q3 through Q4 (recovery start-up qualification only) = 5 years

4. Exempt Contracts Are Not Subject to POC

- Contracts if average tax method annual gross receipts (3 prior years) are less than $29 million
  - Adjust tax return to tax method
- Home construction contracts are exempt from Code Section 460.
  - Home construction contracts defined in Regs. 1.460-3(2).
  - Includes common improvements contractually obligated or required by law.
  - Proposed regulations issued (IRB 2008-39).

4. Exempt Contracts Are Not Subject to POC (continued)

- Residential construction contracts are eligible to use percentage of completion capitalized cost method (POCCCM) (Sec. 460(e)(5)).
  - If required to use POC, 30% of contract is exempt.
  - Definition same as home construction, except for “more than four dwelling units.”
  - Average stay is more than 30 days.
  - Exempt portion uses “normal” (elected) method of accounting.

4. Exempt Contracts Are Not Subject to POC (continued)

- Code Section 460 only applies to long-term construction contracts (460(a)).
  - Does not apply to non long-term contracts.
  - Does not apply to construction management, etc.
  - Use "normal" method of accounting for non long-term jobs and non-construction contract activity (cash/accrual excluding retainage).
  - Revenue Ruling 92-28 allows (requires) use of different methods for exempt and non-exempt contracts within the same trade or business.
- Revenue and expenses are not reported for contracts less than 10% complete (460(b)(5)).

5. Contract Method Changes Allowed if Filed by the End of the Tax Year

- Changes in methods for reporting contract revenue are allowed on a cut-off basis (1.460-4(6)).
- Taxpayer-initiated changes are not permitted or required to report a Section 481(a) adjustment.
- Initial home construction/residential construction contracts elect method on first return.
- Cash and accrual method changes are automatic and allowed up to extended due date of the return.

5. Contract Method Changes Allowed if Filed by the End of the Tax Year (continued)

- Negative 481(a) adjustments for cash and accrual methods are allowed in first year.
- Changes to accrual excluding retainage are automatic.
- Current cost for commissioner approval = $11,500.
- New Form 3115 released December 2022 for use after 4/15/23.

6. Cost Allocation for Contracts Subject to POC Requires Change in Estimated Costs

- Direct and indirect costs must be allocated in the same manner as Regs. 1.263A-1(e) through (h) (Reg. 1.460-5(b)).
- All costs that directly benefit or are incurred by reason of the performance of the long-term contract must be allocated.
- Estimated cost must be adjusted to account for additional cost allocation and projected cost allocation.
- Allocation of bonuses to profitable jobs.
- Allocation impacts look-back returns.

7. AMT Preference Item Only Applies to Certain Long-Term Contracts

- Non long-term contracts are exempt.
- Home construction contracts are exempt (30% residential preference is not exempt).
- 10% election deferral is exempt.
- The difference between POC and tax method of accounting for non-exempt contracts is the preference item.
- Difference due to cost allocation is not a preference.

7. AMT Preference Item Only Applies to Certain Long-Term Contracts (continued)

- C-Corporations are exempt.
- Equipment electing bonus depreciation is exempt.
- Equipment electing Section 179 is exempt.
- Qualified Business Income Deduction is exempt.
- Calculated at owner level for flow-through entities.

8. Look-Back Tax Returns (Form 8697) Are Not Prepared

- Long-term contracts, subject to POC, completed during the year are subject to look-back calculation (includes alternative minimum tax).
- IRS reports 80% of required tax payers DO NOT file.
- Interest refunds on job fades.
- Interest due on gain jobs.
- Home construction contracts are exempt.

8. Look-Back Tax Returns (Form 8697) Are Not Prepared (continued)

- Final contract cost includes costs allocated as required by Code 460(c) and regulations.
- Step-in-the-shoes treatment for mid-contract changes.
- Interest due on claims and post completion settlements are discounted using federal mid-term rates.
- Calculated at owner level for flow-through entities.
- Prior to year-end – review completion of gain and fade jobs.

9. Qualified Business Income Deduction Applies to Contracts

- Be aware of the impact of paying bonuses and guaranteed payments vs. distributions to partners and stockholders.
  - Bonuses and guaranteed payments reduce 20%
  - Deduction distributions **do not**!

10. Failure to Maximize Tax Depreciation Deductions

- Bonus Depreciation on New and Used Equipment (including Qualified Improvement Property) after 2022

2023	80%
2024	60%
2025	40%
2026	20%
2027	0%

10. Failure to Maximize Tax Depreciation Deductions (continued)

- Capitalization not required for repairs and maintenance.
  - Ingram Industries v. Commissioner, T.C. Memo 2000-323
  - Revenue Ruling 2001-4 (Aircraft overhaul)
- Code Section 179 expensing for new or used equipment.
  - $1,160,000 on purchases up to $2,890,000
- SUVs and construction vehicles are exempt from luxury auto limitations.
- Maximize cost segregation for real property and plant construction.
- Write-off obsolete or abandoned equipment (property tax savings).

11. Failure to Utilize Credits

- Energy
  - 45 L Efficient Home Credit
    - Before IRA
      - $2,000 per home/unit
      - Home builders / Developers / Mobile Home Manufacturers
      - Includes Multi-Family / Assisted Living / Student Housing 3 stories or less
      - Certified by 3rd party HERS Rater
    - After IRA
      - Credit increased to $2,500 per unit if Energy Star Certified / $5,000 if Zero Energy Ready Certified
      - Credit limited to $500/$1,000 if prevailing wage requirements not met
  - Electric Vehicle Credit up to $7,500 if produced in the US and if under 14,000 pounds; $40,000 if over 14,000.

11. Failure to Utilize Credits (continued)

- Employment (Work Opportunity Credit).
- Fuel
- Research and Development Credit (and Expense).

12. Failure to Calculate and Maximize the Depletion Deduction on Quarry, Sand & Gravel Operations

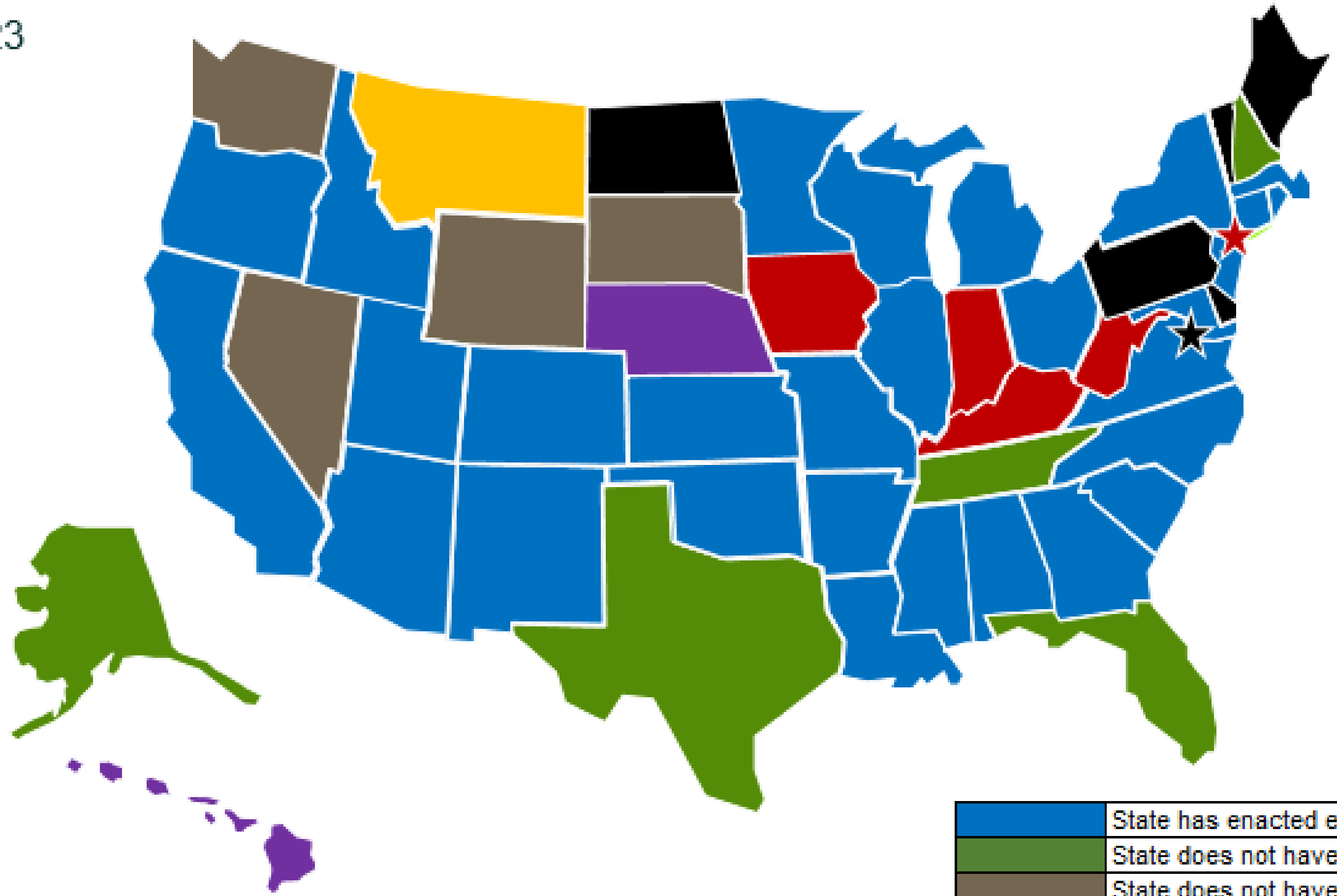
- Percentage depletion equal to 5% of gross sales.
- Limited to 50% of net income of property.
- Available to both lessee and lessor of property.

13. State and Local Tax Pass-Through Entity Regime

- In 2020 – the IRS issued Notice No. 2020-75 on the issue of deductibility of state income taxes for partnerships and S corporations. Specifically, “specified income tax payments” are deductible by partnerships and S corporations in computing the non-separately stated income or loss of the entity.
- **Specified Income Tax Payment (SITP)** is defined as: Any amount paid by a partnership or S corporation (PTE) to a state (including DC), or a political subdivision of a state (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction. The SITP includes any amount paid by the PTE to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the PTE.

13. State and Local Tax Pass-Through Entity Regime (continued)

As of 05/26/2023



(blue)	State has enacted elective pass-through entity tax
(green)	State does not have an individual income tax
(brown)	State does not have an income tax
(black)	No action on pass-through entity tax
(red)	Enacted pass-through entity tax - retroactive to 01/01/2022
(yellow)	Enacted pass-through entity tax - effective 01/01/2023
(purple)	Legislature passed pass-through entity tax, not signed by governor

14. Business Interest Expense Limitations

- Under the TCJA, net business interest is limited to 30% of Adjusted Taxable Income (ATI) (unless certain exceptions apply).
  - Small businesses (less than $29 million in gross revenue) are exempt.
  - Real estate and contractors could elect out,but give up bonus depreciation.
- ATI allowed add back for depreciation expense and interest through 2021.

14. Business Interest Expense Limitations (continued)

- Adjusted taxable income after 2021 will not add back depreciation.

	2021	2022
Taxable Income	$1,000,000	$1,000,000
Net Interest Expense	500,000	500,000
Depreciation	500,000	--
ATI	$2,000,000	$1,500,000
30% Limitation	$ 600,000	$ 450,000

- Confirm that audit adjustments for leasing standards do not add to interest expense!

Questions?

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THANK YOU

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