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Reduce Your Tax Burden Many Deductions and Incentives Are Available to Construction Contractors

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The construction industry pays the highest effective tax rate of any sector of the economy. Given that reality, contractors should be proactive in tax planning, which includes taking advantage of tax incentives and understanding the internal revenue codes specific to contractors when filing tax returns.

This approach will reduce current-year tax burdens, while increasing a contractor's current financial position and improving cash flow for day-to-day operations. Following are several deductions and incentives available to contractors that help reduce tax liabilities.

Depreciation Deduction

Contractors should look to take advantage of the section 179 depreciation deduction, which was made permanent in the Protecting Americans from Tax Hikes (PATH) Act and signed into law in December 2015.

Section 179 allows for up to a \$500,000 depreciation deduction in the year qualified fixed assets are placed into service. The deduction begins to phase out dollar-for-dollar when assets purchased exceed \$2 million. Additionally, a 50 percent bonus depreciation deduction on new qualified property placed into service is possible.

The 179D Deduction

The 179D deduction allows for a tax deduction related to commercial building owners for the reduction of energy usage by improvements to lighting, HVAC systems and the building envelope.

A contractor receives the benefit when work is performed on government buildings. Because government entities are excluded from income tax, the tax incentive can be passed down to the designers or those who work along with the designers of the energy-efficient system being utilized. The types of buildings that qualify as government buildings are government offices, schools, state universities, transportation facilities, post offices, military bases, courthouses and airports.

A deduction of up to \$1.80 per square foot can be applied for energy savings of 50 percent. At the low end of the range, a deduction of 60 cents per square foot will apply for:

- lighting systems meeting 25 percent savings;
- HVAC systems meeting 15 percent savings; and
- building envelope systems meeting 10 percent savings.

Research and Development Credit

The research and development (R&D) credit is one of the most overlooked tax incentives by contractors. This incentive is not a tax deduction; it is an actual dollar-for-dollar credit against taxes owed.

While the term research and development might invoke images of lab coats and scientists, the R&D credit actually applies to new or improved business components. Components consist of products, processes, software, techniques and formulas or inventions.

The IRS established a four-part test to see if the research work being performed qualifies for the credit.

1. **Elimination of uncertainty.** The taxpayer must show that uncertainty has been eliminated regarding the development or improvement of a product or process.
2. **Qualified purpose.** The purpose of the research is to develop or improve a product or process resulting in better performance or quality.
3. **Technological in nature.** Sciences such as engineering, physics, chemistry or computer science must be used in conducting the process or formulating the product.
4. **Process of experimentation.** The taxpayer is required to show that alternatives have been evaluated in achieving the final result.

Contractors continually invest in ways to improve products, processes or techniques, making them eligible for this high-value tax credit.

The PATH Act, signed in December 2015, made significant changes to the R&D credit, including making it permanent. Additionally, the credit can be used to offset the alternative minimum tax (AMT) if average annual gross receipts are less than \$50 million. This is significant for flow-through entities for which income is taxed at the individual level; particularly so for contractors that live in areas with high state taxes and real estate taxes, which often push taxpayers above the AMT threshold.

If a contractor looked into the R&D credit in the past and did not realize a cost benefit because of the AMT, consider revisiting it, as a benefit may now exist.

The R&D credit can be used as a payroll tax credit available for qualified small businesses to reduce FICA tax. Qualified small businesses must be less than five years old with less than \$5 million in annual gross receipts in each of the last five years.

The payroll credit will be up to \$250,000 in payroll taxes per year. Any excess credit can be carried forward to future years. While most startups do not have high income tax liabilities, nearly all of them have payroll tax liabilities. This new opportunity keeps more money in the company, enabling it to grow faster.

Domestic Production Activities Deduction

The Domestic Production Activities Deduction (DPAD) has been available since 2005 and is often missed by taxpayers. It began at 3 percent of income from eligible activities and climbed to 9 percent after 2009. The deduction is limited to 50 percent of wages paid.

The intent of DPAD has always been to provide relief for businesses that produce goods in the United States. It can apply to almost any business that manufactures, grows, extracts, produces, develops or improves goods domestically. The most commonly eligible category of domestic production activities is the construction of real property.

U.S. Code Section 460

Internal Revenue Code Section 460 outlines special rules for long-term contracts that are used by most contractors. It explains available and required accounting methods for income tax reporting, as well as available methods and elections taken by the taxpayer help defer taxable income until future years.

For example, the code allows for the election to defer jobs started that are less than 10 percent complete. This election will defer all income and costs for a job until it surpasses the 10 percent completion threshold.

Additional opportunities enabling contractors to defer income taxes are also available. Remember that it is always best to be proactive as a taxpayer and to consult a tax advisor and attorney to devise an advantageous tax strategy, particularly as the end of the year approaches.

Construction contracting is one of the most difficult industries to understand from a tax perspective. These challenges should not prevent construction business owners from ensuring they take available steps to reduce their current year tax burden.

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