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Everything Contractors Need to Know About the Tax Cuts and Jobs Act

By Ashlie Forum | Sunday, May 5, 2019

Although the total impact of the Tax Cuts and Jobs Act (TCJA) will only be determined with time, certain changes that begin with the 2018 tax year will have an immediate impact on contractors.

CORPORATE TAX RATES AND OTHER BENEFITS

One of President Trump's main campaign promises was to reduce corporate tax rates from the bracketed system ranging from 15% to 35%, to a much lower flat rate.

As part of the TCJA, C corporations are now subject to a flat 21% tax.

Additionally, for tax years ending after Dec. 31, 2017, net operating loss deductions are no longer eligible to be carried back; however, they are eligible to be carried forward indefinitely. Any net operating loss deductions generated post-2017 will be restricted to 80% of taxable income.

Another major change for contractors that operate as C corporations is the elimination of the alternative minimum tax, which was designed to re-compute tax liability by limiting certain deductions and credit items. Prior to the tax law change, C corporations were required to pay the higher of their regular tax liability or alternative minimum tax.

PASS-THROUGH INCOME

To compensate for the reduction in C corporation tax rates and other beneficial changes, the TCJA gives owners of certain pass-through businesses, including S corporations, LLCs, partnerships and sole proprietorships, a deduction equal to 20% of the business's income on their individual tax returns. Construction companies are specifically noted as being allowed to take this deduction.

For taxpayers who are single and those who file married joint returns, and have taxable income greater than $157,500 and $315,000, respectively, the deduction can be limited by wages the business pays and the amount of capital assets owned.

INDIVIDUAL INCOME TAX

Most contractors should see a lower effective tax rate on their individual tax returns due to shifts in individual tax brackets. The largest reduction occurs within the highest tax bracket. In 2017, income exceeding $470,700 was taxed at the top marginal rate of 39.6%, while in 2018 the highest bracket begins at $600,000 and is set at 37%.

Following are other changes for 2018.

The standard deduction has been almost doubled to $12,000 for single taxpayers and $24,000 for married filing joint taxpayers, and personal exemptions are eliminated.

The deduction for state and local income, sales and property taxes is capped at $10,000, adversely affecting taxpayers in high tax states such as New York, New Jersey, Connecticut and California.

Mortgage interest is deductible for new debt balances of $750,000 or less (compared to $1 million previously), and interest on home equity loans is no longer deductible unless the funds are directly connected to the underlying property.

The phase-out of 3% itemized deductions for taxpayers with incomes exceeding $313,800 (married filing jointly in 2017) has been eliminated.

INCOME REPORTING METHODS

One of the most beneficial TCJA changes for contractors is how income is reported. Contractors with average annual gross receipts below $25 million will now be able to use the cash or completed contract method for tax purposes. Three prior years of gross receipts is averaged to determine the taxpayer’s average annual gross receipts for the purposes of this test.

Prior to the TCJA, the average annual gross receipts threshold was $10 million ($5 million for corporations and partnerships with corporate partners). Contractors that exceed the new $25 million threshold are required to report gross profit from long-term projects under the percentage-of-completion method.

For 2018, contractors that fall below the new revenue threshold can elect to be exempt from reporting income on the percentage-of-completion basis.

DEPRECIATION

Another major benefit contractors will reap from the TCJA is the ability to fully expense any new or used assets that are eligible for bonus depreciation. Any bonus-eligible assets purchased after Sept. 27, 2017, and through 2022 can be 100% expensed in the year of purchase.

Also, contractors will benefit from changes to Section 179, which states that assets purchased to improve nonresidential real estate, such as roofs, HVAC systems and fire protection systems, are deductible up to $1 million assuming the contractor has sufficient taxable income.

INTEREST EXPENSE

Some changes could negatively impact contractors. Beginning in 2018, deductible interest expense will be limited to 30% of the business's adjusted taxable income. Businesses with gross receipts less than $25 million will be exempt from this rule. Although interest expense incurred in excess of the 30% threshold is carried forward indefinitely, large contractors with high levels of debt should consider renegotiating debt or at least conducting an analysis.

DOMESTIC PRODUCTION ACTIVITY DEDUCTION (DPAD)

The TCJA eliminates the DPAD, a popular deduction typically available to manufacturers, contractors, engineers and architects that manufacture and produce goods in the United States. DPAD allowed for a deduction up to 9% of qualified income.

EXCESS BUSINESS LOSS LIMITATION

Individuals will only be able to deduct $500,000 of net business losses on their tax returns. Excess amounts will be carried forward. With the additional deductions available to contractors, it will be more important than ever to review tax projections during the year to maximize planning opportunities.

MEALS AND ENTERTAINMENT

Meals provided to employees at the convenience of contractors were formerly 100% deductible and will now be limited to 50% deductibility. Entertainment expenses are no longer deductible.

The deduction for business meals with clients remains at 50%, but tickets for client entertainment can no longer be deducted. Expenses for events such as company parties and meals provided during training remain fully deductible.

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