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Save Cash Using a Tax Deferral Strategy

Construction Contractors Can Defer Taxes to Keep More Cash on Hand

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Cash is essential to running day-to-day operations and improving a company's financial position when presented to banks and other creditors, so contractors continue to search for ways to keep cash available. One of the best opportunities to keep more cash in the company is to create a tax deferral. Tax deferral strategies for contractors are often overlooked or misunderstood.

Tax deferral refers to instances in which taxpayers can delay paying taxes until some future period. Contractors should take full advantage of the opportunity to create tax deferrals whenever possible to maximize cash flow. In some situations, a deferral can be significant, especially for flow-through entities.

Internal Revenue Code 460 is a special tax code directed entirely to long-term construction contracts. It provides for several possible tax deferral strategies for contractors. To create a tax deferral strategy, begin by identifying the type of construction contract in place.

Identify the Construction Contract

Exempt Construction Contracts

Exempt construction contracts are exempt from reporting income on the percentage of completion. A taxpayer who has average annual gross receipts of less than $10 million and estimates contract completion within 24 months is an example.

There are several different accounting methods available for exempt construction contracts. It is important to select a method that is allowed and benefits the taxpayer. Common accounting methods for exempt contracts include the completed contract, cash basis and accrual methods.

- **Completed contract method:** The exempt method that often achieves maximum deferral is the completed contract method, under which all costs and revenues are reported when the contract is completed and accepted. Accordingly, tax on the contract is also deferred until

completion. One negative of the completed contract method is that a loss on a contract is similarly deferred.

- **Cash method of accounting:** When using the cash method of accounting, income is recognized when received and expenses are recognized when paid. This method benefits contractors with large receivable balances, preventing income from being taxed before cash is available to pay the taxes.
- **Accrual method:** The accrual method is the least beneficial for contractors with long-term contracts. It is common for contractors to generate over-billings at the start of a contract to help finance the work. Using the accrual method causes these over-billings to become taxable. The accrual excluding retainage method is similar to the accrual method of accounting; the difference is that retainage receivable and retainage payable are excluded from taxable income.

Select the Accounting Method

The accounting method used is based on the type of contract, not the contractor. A tax return can be reported using several different methods. A small contractor that has average annual gross receipts of less than $10 million can use the completed contract method for the exempt contracts. Percentage of completion would be required for any contracts estimated to take longer than 24 months. Short-term contracts will be on the taxpayer's elected overall method of accrual, excluding retainage.

Percentage of Completion Method

Tax deferrals do not stop with exempt construction contracts. Contractors with long-term contracts and average annual gross receipts in excess of $10 million can still create deferrals using the percentage of completion method.

IRC 460 states that a contractor using the percentage of completion method must allocate direct costs and certain indirect costs to contracts. This additional allocation of costs helps modify reportable income by adjustments to estimated costs that are based on reasonable assumptions. This modification can result in a lower percent complete, deferring income in the current period. An election can also be made to defer any revenue and cost until the contract is more than 10 percent complete.

Additional Tax Strategies

Contractors have several additional ways to reduce current-year taxes. The Research and Development (R&D) Tax Credit and 179D deduction are often overlooked.

- **The R&D credit** is a dollar-for-dollar reduction in taxes for money spent on a new or improved business components. Eligible components include a product, process, formula, technique or invention.
- **179D** is a deduction of up to $1.80 per square foot for the reduction of energy relating to lighting, heating and cooling, and building envelope. 179D is a deduction to the business owner, but can be passed on to the designer or those working with the designer on government projects such as state universities, transportation facilities, government offices, schools and courthouses.

A tax deferral is not a tax savings. It is a cash flow strategy that can be advantageous to maintaining fluid operations. A taxpayer must understand the deferral strategy and have a plan for timing the creation of the deferral and subsequently unwinding it. This decision is usually based on backlog.

All contractors should be aware of tax deferral strategies and tax savings opportunities that are available to them. Always be proactive in consulting with your tax advisor to find ways to keep more cash on hand.

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