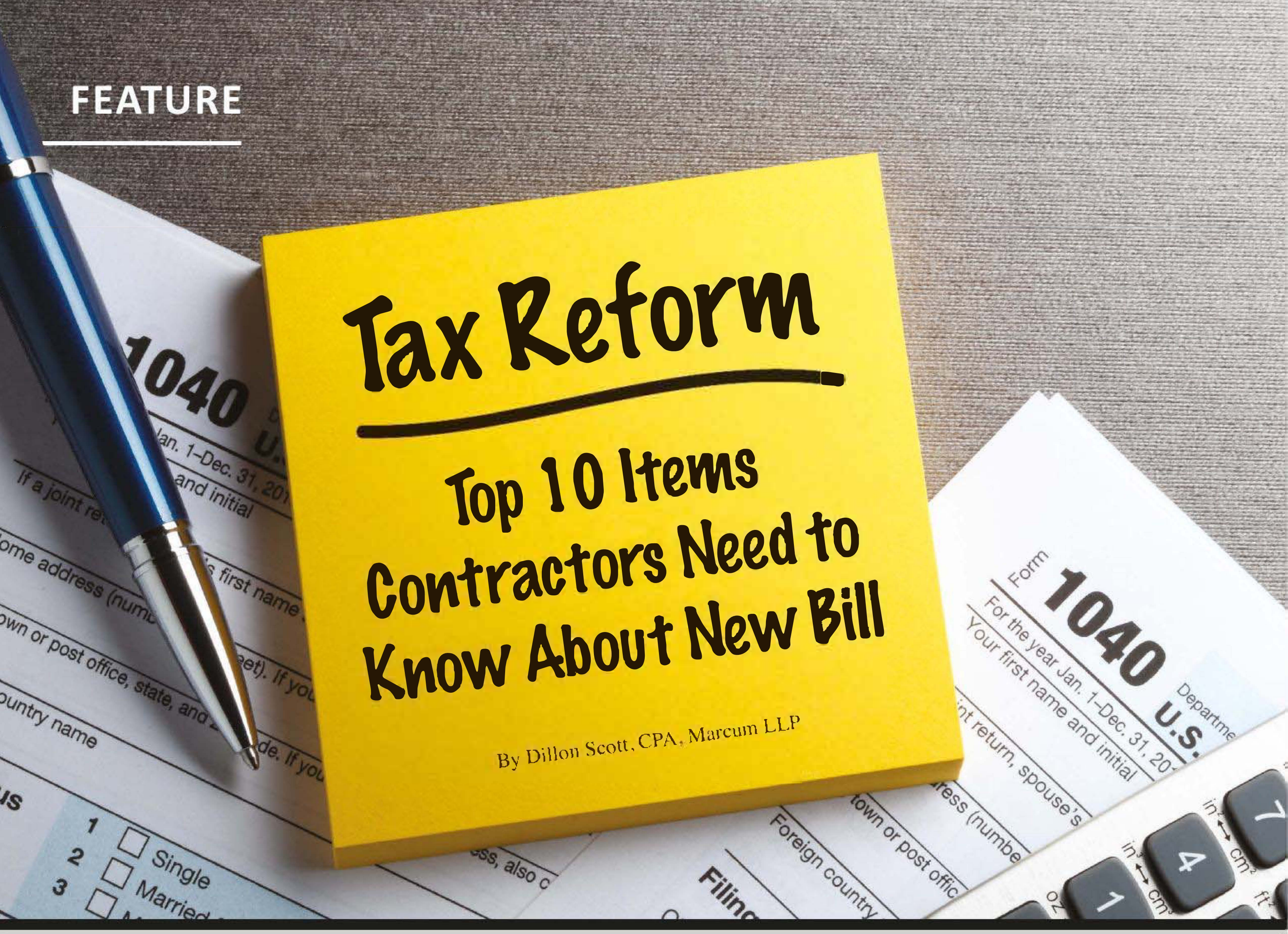

The "Tax Cuts and Jobs Act," signed into law on Dec. 26, 2017, was introduced to provide incentives for American businesses and simplify the tax code for more Americans. The former may materialize, while the latter is likely an unrealistic goal for all but the most basic tax situations.

Our piece in the *Tennessee Road Builder*, November-December 2017 issue, "Special Tax Planning Considerations for Contractors," touched on the bill as proposed by the House and Senate at that time. Fortunately, most of that information turned out to be in line with the end product, but the unknown, unmentioned and extreme changes necessitate an update. In the spirit of David Letterman and ever-shrinking attention spans, we have compiled a list of the "Top 10" changes that will affect contractors in 2017 and beyond.

1) Flat 21% Tax Rate for C-corporations

C-corporations will enjoy a flat 21 percent tax rate rather than a blend of eight brackets ranging from 15-39 percent. For the construction industry this generally translates to a tax cut for corporations with net income in excess of $120,000. The new tax rate takes effect in years beginning after Jan. 1, 2018, so calendar-year corporations will pay 21 percent for their entire year while fiscal year-end companies will pay a blended rate. Taxable income will be pro-rated at the 21 percent rate for the months in 2018 in which it was earned. To help illustrate some of the effects:

Comparison of C-corporation with December 31st year-end and $500,000 net income.

C-corporation with 12/31 Year-End

	2017	2018
Net Income	$ 500,000	$ 500,000
9% DPAD* (eliminated by tax act)	$ (45,000)	
Taxable Income	$ 455,000	$ 500,000
Total Tax	$ 154,700	$ 105,000
Effective Tax Rate	30.9%	21.0%

*Domestic Production Activities Deduction

Comparison of C-corporation with June 30th year-end and $500,000 net income.

C-corporation with 6/30 Year-End	2017	2018
Net Income	$ 500,000	$ 500,000
9% DPAD (eliminated by tax act)	$ (45,000)	
Taxable Income	$ 455,000	$ 500,000
Half of income taxed under 2017 rates		$ 77,350
Half of income taxed under 2018 rates		$ 52,500
Total Tax	$ 154,700	$ 129,850
Effective Tax Rate	30.9%	26.0%

2) 20% Deduction for Pass-Through Business Income

Owners of pass-through businesses, such as S-corporations, LLCs, partnerships and sole proprietorships will be able to take a deduction equal to 20 percent of the business income on their individual tax return. This 20 percent deduction can be limited for companies with minimal payroll expenses and capital expenditures. Such limitations should not impact most construction contractors. A simple illustration of a business owner's tax return follows:

Comparison of a married couple's tax liability with pass-through net income of $500,000 and no itemized deductions:

Owner's Tax Return	2017	2018
Income from pass-through entity	$ 500,000	$ 500,000
9% DPAD deduction (eliminated by tax act)	$ (45,000)	
Adjusted Gross Income (AGI)	$ 455,000	$ 500,000
20% business income deduction		$(100,000)
Standard deduction (increased by tax act)	$ (12,700)	$ (24,000)
Taxable income	$ 442,300	$ 376,000
Total Tax	$ 121,688	$ 83,699
Effective rate on business income	24.3%	16.7%

Note: While the gap between the new corporate and individual tax rates may make a high-earning C-corporation appear desirable, many factors need to be considered before making a decision. The double taxation of distributions (i.e. – dividends or property/cash distributions upon sale of the company's assets) from the corporation can quickly negate any lower front-end tax rate. Entities need to review all relevant facts and circumstances before deciding to form or convert to C-corporation status.

3) 100% Depreciation of Equipment & Improvements

Equipment purchased between Sept. 27, 2017-Jan. 1, 2023 may be entirely expensed under what is known as bonus depreciation. Current law allows for the deduction of 50 percent of the cost of new assets and was scheduled to phase out by 2020. The new tax law allows assets – either new or used – to qualify for the 100-percent deduction as long as it is the business' first-use of that asset. This is now scheduled to phase out between 2023 and 2026.

The Section 179 deduction (which allows the write-off of purchased assets) has been increased from its current limit of $510,000 to $1,000,000. Assets purchased to improve nonresidential real-estate, such as roofs, HVAC systems and fire protection systems now qualify for this special deduction, whereas they were previously required to be depreciated over a long period (generally 39 years). Between bonus depreciation and Section 179, most or all of the assets purchased by a construction company will likely be written off for tax purposes. Be aware, however, that many states will continue to disallow bonus and/or Section 179 deductions. The distinction is important in Tennessee because Section 179 deductions are allowed but bonus-depreciation amounts are not, and are therefore added back to net income for excise tax purposes.

A trade-off of the 100-percent depreciation is the elimination of "like-kind exchanges" on trade-ins of equipment. Previously, a business owner could trade in equipment when purchasing a similar piece and not pay tax on the trade-in value given for the old asset. The tax law now limits that deferral to real-estate assets.

4) More Contractors Can Use Cash or Completed Contract Method to Report Income

Contractors with gross revenue of up to $25 million will be able to use the cash or completed contract method for tax purposes. For some construction companies this may be the most-important change in the new law. Since 1986, the tax code has used a revenue threshold of $10 million as the definitive line between a "small" and "large" contractor. A large contractor is required to report gross profit from long-term projects under the percentage-of-completion method. As a result, the ability to defer recognition of income for tax purposes is diminished. Inflation has caused many more companies to be classified as "large" than what was intended.

Beginning in 2018, contractors that fall below the new revenue threshold will be exempt from reporting income on the percentage-of-completion basis. If the taxpayer previously exceeded the $10 million amount, they will be allowed to automatically change their method of accounting for long-term contracts to the cash or completed contract method for tax purposes. Three prior years of revenue is averaged to determine the taxpayers' "average annual gross receipts" for the purposes of this test. Contractors should review their business models to determine which method(s) may be the most beneficial. If it appears you will be below the $25 million limit, 2018 is a great time to determine which method would be most beneficial going forward.

5) Changes to the Alternative Minimum Tax

The Alternative Minimum Tax (AMT) has been repealed for corporations but remains for individuals. Owners of companies often see AMT result from accelerated depreciation of equipment, the treatment of long-term contracts and a disallowance of state taxes. Certain limitations within the calculation have been raised, which should mean fewer taxpayers will pay the AMT, but the true impact on business owners – specifically in the construction industry – remains to be seen. This should be included in contractors' annual tax planning considerations.

6) 9% Domestic Production Activities Deduction (DPAD) Terminated

You may have noticed in the examples above that no deduction was taken in 2018 for DPAD. Due to the business income deduction and other changes, Congress has eliminated the popular 9-percent deduction typically available to manufacturers, contractors, engineers and architects.

7) Individual Tax Rates Lowered & Deduction Changes

Most taxpayers should see a lower effective tax rate (tax/taxable income) due to the shifts in the individual tax brackets (see the example in No. 2).

The largest move occurs in the highest tax bracket. In 2017, income more than $470,700 is taxed at the top marginal rate of 39.6 percent, while in 2018, the highest bracket begins at $600,000 and is only 37 percent.

About 30 percent of taxpayers currently itemize deductions, and the Tax Act is designed to reduce that number even further (simplification!). For brevity's sake, highlights of the changes are below:

a) The standard deduction has been almost doubled to $24,000 (married-filing-joint) and personal exemptions have been eliminated.
b) The deduction for state and local income, sales and property taxes is capped at $10,000, adversely impacting taxpayers in states like New York and California.
c) Mortgage interest will be deductible for debt balances of $750,000 and less, whereas the limitation was $1 million prior; and interest on home equity loans is no longer deductible.
d) Additionally, alimony deductions are also no longer allowed and will not be taxable to the recipient for divorce agreements entered into after 2018.
e) The phase-out of 3 percent itemized deductions for taxpayers with incomes in excess of $313,800 (married-filing-jointly in 2017) is eliminated by the new law in 2018, and beyond.

Married Filing Jointly

2017			2018		
TaxRate	From	To	TaxRate	From	To
10%	$ -	$ 18,650	10%	$ -	$ 19,050
15%	$ 18,650	$ 75,900	15%	$ 19,050	$ 77,400
25%	$ 75,900	$ 153,100	25%	$ 77,400	$ 165,000
28%	$ 153,100	$ 233,350	28%	$ 165,000	$ 315,000
33%	$ 233,350	$ 416,700	33%	$ 315,000	$ 400,000
35%	$ 416,700	$ 470,700	35%	$ 400,000	$ 600,000
39.6%	$ 470,700	∞	39.6%	$ 600,000	∞

8) Limitation on Interest Expense Deductions

The rule will limit interest expense to 30 percent of the business' adjusted taxable income, or EBITDA (see below). Businesses that fall below the $25-million revenue threshold will be exempt from this rule, much like their exemption from the percentage-of-completion method. Real-estate entities may opt-out of this rule, but will sacrifice their bonus depreciation from No. 3 above. A large contractor with high levels of debt should be cognizant of this and may find it beneficial to reduce or renegotiate debt to avoid triggering the limitation.

In the following example, there are two companies with earnings before interest, taxes, depreciation and amortization (EBITDA) of $2,000,000, which limits interest expense to a maximum of $600,000

(30 percent). $150,000 of Company B's interest expense is therefore non-deductible in this year (can be carried forward indefinitely):

	Company A	Company B
Revenue	$ 100,000,000	$ 100,000,000
Direct costs	$ (93,000,000)	$ (93,000,000)
Gross profit	$ 7,000,000	$ 7,000,000
General and administrative expenses	$ (5,000,000)	$ (5,000,000)
Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) - "Adjusted Taxable Income"	$ 2,000,000	$ 2,000,000
Depreciation	$ (1,000,000)	$ (1,000,000)
Interest expense	$ (500,000)	$ (750,000)
Net income	$ 500,000	$ 250,000
Non-deductible interest expense (> than 30% of EBITDA)	-	$ 150,000
Total taxable income	$ 500,000	$ 400,000
Interest expense limitation (30% of EBITDA)	$ 600,000	$ 600,000

9) Gift & Estate Tax Exclusion Doubled

Important to those performing succession and estate planning, the gift and estate tax exclusion amount has been doubled from $5.49 million to $11.2 million per person, or $22.4 million for married couples. This will allow a larger amount of assets, such as business interests, stock and real-estate, to be transferred to heirs tax-free.

10) Entertainment Expense Deduction Eliminated

Business meals remain 50 percent deductible, but those hockey tickets for client entertainment can no longer be claimed. However, expenses for events such as company parties, meals provided during training and the like remain fully deductible. Businesses should be certain to record such expenses clearly and separately in their books to prevent the mingling of deductible and non-deductible costs.

The new tax law brings with it a host of new challenges for contractors and accountants alike, but it will not be without benefit. A "technical corrections" bill usually follows major tax legislation to resolve unintended consequences. More than most recent years, it will be important to stay up to date and to consider all tax planning alternatives available to construction companies and their owners. This will not be a good year for "business as usual!"

One of the leading construction accounting firms in the U.S., Marcum LLP's Construction group provides audit, consulting and taxation services to clients ranging from start-ups to multi-billion-dollar enterprises. Dillon J. Scott, CPA, specializes in construction accounting and taxation for entities and individuals. He is with the Nashville office of Marcum LLP and can be reached at dillon.scott@marcumllp.com, or (615) 245-4058.