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Making the Cut

After a chaotic legislative session, Congress delivered a massive overhaul to the tax code. But what does it mean for electrical contractors?

Matthew Halverson | Jul 17, 2018

Please excuse the dust at Bret's Electric for the next few months. In mid-May, the Frederick, Colo.-based electrical contractor moved from its original 5,000-square-foot facility to a new building twice that size across town. In addition to other efficiencies that extra space will create for the company, it will allow crews to begin prefabricating and get products out to clients more quickly, none of which would have been possible without the introduction of the Tax Cuts and Jobs Act of 2017.

"This has been like a breath of fresh air," says Bret's Electric Vice President Janet Martin.

Like most Americans who followed the 2016 Presidential campaign, Martin heard then-candidate Donald Trump declare, among other things, his intention to simplify the "complex" and "burdensome" tax code and implement cuts that would prioritize the needs of small businesses above all others. That was, understandably, music to her ears. And though the final bill President Trump signed into law on December 22, 2017, included provisions that were markedly different from what he'd promised on the campaign trail, Martin was more than satisfied with the final product.

"In the past, most of our money went to pay for federal needs, restricting our ability to grow our business," she says. "So we were hoping President Trump would make good on his word. And he did."

To unpack exactly how he made good on his word, you'd need a PhD in accounting. (Even then, one of the tax preparers contacted for this article described the process of parsing each revision to the bill pre-passage as "mind-numbing.") However, we've done our best here to lay out the changes to the tax code that will affect electrical contractors and how to prepare for them. Don't have time to read further and need the Cliff's Notes? Call your accountant — like yesterday!

As certain as death and…

Let's start with the bad news. No more deducting entertainment expenses, period. And forget about taking clients out to expensive lunches or dinners and then deducting 50% of the entire tab. Under the new rules, you'll only be able to write off half of your meal (and anything your employees eat).

“You see how that’s going to impact what you’re going to do with meals,” says Scott Morrison, a managing partner with Morrison Clark & Company, a Chandler, Ariz.-based accounting firm that works with construction firms. (The day before speaking to EC&M, he’d met with 30 business owners to explain these changes in detail.) “You have to be very careful with the way that you account for meals going forward.”

In fact, it’s good to keep in mind that this rule — and every other one outlined in this article — took effect on Jan. 1, 2018. Therefore, if you haven’t adjusted the way you operate yet, now’s the time to start.

Then there are the changes related to the purchase of equipment, specifically trade-in allowances. In the past, if you wanted to buy, say, a new wire-puller — and the dealer gave you trade value for your older, fully depreciated model — you wouldn’t be taxed on the paper gain on sale. That’s no longer the case. Even though you didn’t technically pocket any cash on the transaction, you’ll still pay taxes on the amount the dealer gave you for the trade-in. In other words, before you sign for any equipment, make sure you have enough cash to cover the tax you’ll owe on the cash you didn’t earn.

This brings us, finally, to the Domestic Production Activities Deduction (DPAD). Written into law in 2004 and phased in over the next six years, DPAD ultimately allowed manufacturers and contractors that produced goods domestically to deduct 9% of their income. Well, that went away with the Tax Cuts and Jobs Act, too.

Right about now you may be wondering, I thought President Trump’s tax reform was supposed to be a boon for business? What’s in this for me? That’s the first question every one of James Lundy’s contractor clients has asked him since the bill was signed last year.

“What we’ve told them is, ‘You have to go back to the campaign and remember why we even had tax reform,’” says Lundy, an accountant and partner at Marcum LLP, in Nashville. “The stated goals of tax reform were to bring jobs back to America and get companies to reinvest in America. From his 30,000-foot viewpoint, the way to do that was to reduce the corporate tax rate.”

And though an outline for tax reform released by the Trump administration in late September 2017 promised an across-the-board tax rate for small businesses of just 25% — down from, on the high end, 39.6% — that never came to pass. Instead, for the next three months, the Senate and House batted around several versions of the massive bill in a chaotic dash to the finish, finally settling on a cut of just 2.6%. Corporations, on the other hand, received a 10.67% cut.

Cutting through the confusion

Liam Donovan was never concerned that the White House and GOP-controlled Congress wouldn’t come through for small businesses. The former lobbyist and current partner at Washington, D.C.-based law and government relations firm Bracewell says it was just a matter of making the numbers work.

“As important as the corporate community is, small and mid-size businesses are really critical, and we can’t put them at a competitive disadvantage,” he says. “We’ve spent the last seven years educating the Hill on how important it is to take care of both sides of that equation.”

In the end, a compromise came by way of the Qualified Business Income Deduction, which effectively replaced the DPAD. And it amounts to a significant cut: Those who qualify can deduct

20% from their annual income. Combined with the modest cut for small businesses, the deduction reduces the effective top tax rate to 29.6%. Of course, “those who qualify” and “can” are the operative words.

To whom the deduction applies shouldn’t be a big surprise: sole proprietorships, partnerships, and S corps, or those companies in which business income passes through to the owner, who then reports that income on his or her tax return. Since we’re dealing with the tax code, how the deduction applies is exceptionally convoluted. Rather than get down into the weeds, Lundy explains just how tricky it can get: “The deduction can’t exceed more than 50% of your wages,” he says. “But if you don’t pay enough wages, you go to a different calculation that says the 20% can’t exceed 25% of your wages plus 2.5% of the original cost of your fixed assets.”

That just scratches the surface of how complicated the new law can get, but it’s of a piece with the entire process that led to — and through — the bill’s passage. As one change after another was proposed, debated, and either added to or struck from the bill, it was only natural that confusion would set in for the average contractor who tried to follow along with the daily updates. (One contractor contacted for this story in May — a full five months after the bill was passed — was under the mistaken impression that the tax rate reduction for C corporations applied to S corporations as well.)

Bracewell’s Donovan works with the Associated Builders and Contractors, and though he’s happy with the bill’s end result, he says he spent the first half of 2018 helping to allay the fears of contractors who had trouble parsing the proposed changes and educating those who were too focused on work to keep up with every new development coming out of D.C.

“There was so much churn and so many iterations of the tax reform bill, and that led to misinformation,” he says. “Over the last five months, we’ve put forth a lot of effort to say, ‘Okay, you heard a lot about this, but here’s where it is. Here’s what it means for your expensing of large equipment. Here’s what it means if you’re a pass-through.’”

Unfortunately, it’s not just those business owners directly affected by the new laws that are scrambling to catch up. The accountants themselves are behind the eight ball — and not for a lack of trying.

“I’ve created Excel formulas for how I think the new deduction will be applied, but I don’t have a single IRS-approved, Congressional anticipated form that says, ‘This is what’s going to happen,’” says Morrison. “We’re not completely in the dark, but we are waiting for guidance from Congress on what they intended and what the math was supposed to result in.”

Some of that is to be expected in the wake of the biggest change to the tax code in 30 years, but both Morrison and Lundy agree that this is an exceptional case.

“One of the reasons this is different is that the bill was passed in such a haphazard way, at the eleventh hour,” Lundy says. “Plus, the poor IRS has been so defunded that they hardly have enough people to help us out. Usually, they send out some explanations fairly quickly. But not this year.”

Given the complicated nature of the changes, it’s best to leave the details to your accountant. After all, that’s what you pay him or her for. However, that doesn’t mean you can continue doing business as usual and expect to just reap a big tax benefit at the end of the year — because what you’ve done in the past could end up hurting you in the future. And we’re already more than six months into the new tax year.

Both Morrison and Lundy recommend meeting with your accountant sooner, rather than later, in order to get all of your financial ducks in a row.

“Usually, we’ll visit all of our clients in November and December and say, ‘If the year ended right now, what would your financial statement and tax return look like? What about your bonding, your equity, your lines of credit?’” Lundy says. “This year we’re pushing to get it done as soon as possible.”

Econ 101

Put Mark Fleming in the camp of contractors who are on the fence about how the Tax Cuts and Jobs Act will affect them directly — but that doesn’t mean he’s not bullish about the future. Fleming is the CEO of Corbins Electric, a Phoenix-based electrical contractor that does most of its work in the high-tech industrial sector. Business flagged for years after the market crashed in 2008, but Corbins bounced back in a big way in 2016 and ’17, with 60% and 90% growth, respectively.

Fleming attributes that upswing, in part, to the business-friendly Trump administration and the jolt it has given to the economy since the beginning of last year. Regardless of whether the new tax laws ultimately improve his bottom line, he prefers to take a longer view.

“After having gone through the Great Recession, people in our industry are much more cautious,” he says. “Prior to the tax reform bill being voted on, I was concerned that improvement in the economy might have just been a false start that could easily backslide. But now I have much more confidence in investing in our company.”

On the surface, it’s hard to argue with that logic. But Bernard Markstein, an economist who focuses on the construction industry, cautions that the “rising tide raises all boats” philosophy may not apply in this instance. For one, corporations that will benefit the most from the tax cuts — and will therefore, in theory, be willing to spend more money on capital improvement — were already sitting on large sums of money that they could have been putting toward construction projects when interest rates were at their lowest.

Not only that, the construction industry as a whole is reaching full employment after having hit an unemployment rate of 24.9% in spring 2010. With the ongoing skilled labor shortage, it may be difficult to staff any of the hypothetical work spurred by tax reform.

“The tax cut appears to have stimulated some investment here and there, although it’s hard to tell how much of that is new and how much would have occurred anyway,” Markstein says. “But there hasn’t been this opening of the flood gates that some predicted.”

Of course, if we’ve learned anything from the last decade, it’s that the economy — and political landscape — can change on a dime. So long story short, contractors would be best served reassessing how they do business, discussing the changes to the tax code with their accountant, and not take anything for granted.

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