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The contractor's tax-credit strategy guide

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With supply chain dynamics, inflation and rising material costs, contractors are experiencing heightened pressure on their margins. Reducing income taxes through effective planning is one way to put cash back into contractors' pockets.

The following will take a quick look at several tax savings strategies.

Section 179D & Section 45L

On Aug. 16, 2022, Congress passed the Inflation Reduction Act of 2022 (IRA), which extended and created energy-efficiency tax benefits. Sections 179D and 45L are two energy-tax savings ideas that contractors should consider.

1. *Section 179D* — Section 179D is a deduction for commercial builders. The tax deduction provides of up to $1.80 per square foot for the installation of systems that reduce the total energy and power costs. For tax years beginning after Dec. 31, 2022, the maximum deduction increases to a sliding scale between $2.50 and $5 per square foot, depending on the energy-efficiency increase with respect to the Reference Standard 90.1. Below is a summary of certain rules:
   • Commercial building owners and designers of buildings owned by government entities and not-for-profit organizations are eligible.
   • Equipment must be installed with a plan to reduce total annual energy and power costs of the building by 25% to 50%.
   • Prevailing Wage Requirement & Apprenticeship Requirement — In order to take certain deductions under 179D, contractors need to ensure that they meet local prevailing wage and apprenticeship requirements for employees.
2. *Section 45L* — Section 45L is a tax credit that promotes the construction of energy-efficient residential dwellings. This allows the developer to claim a tax

credit for each dwelling unit. The IRA extended the section 45L credit to the tax year ending Dec. 31, 2032, and increased the credit per unit from $2,000 to a maximum of $5,000. Section 45L was allowed for residential buildings with no more than three stories. The IRA removed the high restriction in 2023.

Employee Retention Credit

The Employee Retention Credit (ERTC) established by the Coronavirus Aid, Relief and Economic Security (CARES) Act has proven to be a great benefit for taxpayers who experienced hardship during tax years 2020 and 2021. Consider these key points when evaluating the potential benefits of this credit.

- If you experienced a governmental shutdown or a decline in gross receipts related to tax years 2020 and 2021, you may be eligible for the ERTC.
- Originally, contractors were not allowed to obtain the Paycheck Protection Program (PPP) loan and claim the ERTC; however, the CARES Act changed this, and contractors are now eligible to take advantage of both if eligibility requirements are met.
- The ERTC is claimed by amending payroll tax return Form 941.
- For 2020, eligible employers can claim a credit equal to 50% of qualifying wages (up to maximum of $10,000) per employee.
- For 2021, eligible employers can claim a credit equal to 70% of qualifying wages (up to maximum of $10,000) per quarter per employee.

State & Local Tax Workaround

The IRS has given notice to allow deductions as business expenses at the entity level for state and local taxes imposed and paid by the entity, instead of carrying such payments as nondeductible itemized deductions over the current tax maximum of $10,000. The pass-through entity would then pass through to the taxpayer this business deduction as a credit for each state.

This needs to be evaluated on a state-by-state basis since each state has its own set of rules. Some of these elections need to be made by the partners/shareholders and not the entities.

Bonus Depreciation — Section 168(k)

Currently, certain assets are eligible for bonus depreciation, which means contractors can write off a percentage of the cost of the asset when purchased. Percentages are as follows:

- 2023: 80% bonus depreciation
- 2024: 60% bonus depreciation
- 2025: 40% bonus depreciation
- 2026: 20% bonus depreciation
- 2027: 0% bonus depreciation

Business Interest Limitation Depreciation Changes — Section 163(J)

This interest limitation was implemented in the Tax Cuts and Jobs Act (TCJA) of 2017, which limited business interest expense to 30% earnings before interest, taxes, depreciation and amortization (EBITDA) (50% for 2019 and 2020).

In prior years, taxpayers were able to add back to their taxable income depreciation expense, which helped increase the amount of the interest expense deduction. However, starting with the tax year ending Dec. 31, 2022, this will not be allowed, which could drastically decrease some taxpayers' ability to deduct interest expense.

There are two exemptions that contractors should consider when it comes to tax planning:

1. Small businesses are exempt of this limit. Small businesses for tax year 2022 are those with an average of less than $27 million in gross revenue in the prior three tax years.
2. Real estate and construction businesses can elect to be treated as an electing real property trade or business. Taxpayers will not be subject to the interest expense limitation under this election, but will need to adopt the alternative depreciation system (ADS) for all nonresidential real property, residential rental property and qualified improvement property. The ADS requires assets to be depreciated over a slightly longer useful life. In addition, bonus depreciation is not allowed on these assets.

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