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Tax changes on the horizon: What contractors need to know

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As the end of 2020 approaches, even as many construction businesses are still struggling with the fallout from the COVID-19 pandemic, it's time to close out the year financially. That means it's time for tax planning and the consideration of other financial issues, both of which will hopefully put contractors in the best position to take on 2021.

While the smart move is to consult tax and accounting experts in order to properly address the situations that are unique to every business, there are some basic talking points that can help business owners and managers kickstart that conversation. Here are some of the most pertinent:

Changes in accounting methods

The construction industry is unique in that contractors are expected to use different methods of accounting in order to pay the least amount of taxes possible and, at the same time, to present a robust financial picture to lenders and other stakeholders, said James Lundy Jr., construction services tax leader in accounting firm Marcum LLP's Nashville, Tennessee, office.

"The tax code is designed to allow construction contractors to record one set of dollars to the bank and another set of dollars to the IRS," Lundy said during a recent Marcum webinar. "It has us keeping two sets of books, and it's totally legal."

All contractors, he said, must use the percentage-of-completion method of accounting for financial reporting, but for tax purposes there are several types of accounting methods that can be used on each tax return with as many as four routinely used at once. Overall tax methods include:

- Cash
- Accrual

- Accrual, excluding retainage

Accounting methods for long-term contracts, which are defined as starting in one year and ending in another, include:

- Completed contract
- Percentage of completion
- Tax percentage of completion
- Percentage of completion-capitalized cost method

The reason that it's important to consider what method a contractor will use for tax purposes as part of 2020 planning is that some changes from one method to another require that a request be filed with the IRS before the end of the tax year. Choosing the correct method or methods, Lundy said, should allow the contractor to save on and/or defer as much of its tax burden as possible.

Presidential and congressional changes

In a typical year, many contractors maximize their deferred taxes by holding off on collecting receivables, pushing that deposited income into the next year, said Michael Ceschini, managing member at Ceschini CPAs Tax & Advisory in New York. Businesses can also accelerate or add to total expenses for the year by making major purchases, paying out bonuses and paying invoices by Dec. 31, further decreasing tax liability.

However, 2020 is no typical year. Right now, contractors have to decide, with their financial advisers, how they want to factor in the effects of a President-elect Joe Biden tax plan into their end-of-year strategy.

Among other changes to the tax code, Biden is expected to increase the corporate income tax rate from 21% to 28%, said Frank Scala, partner of Marcum's Assurance Services Group in New York City, and to raise individual tax rates for those making more than $400,000 per year. The latter would impact company shareholders who report business earnings on their personal returns via ownership in pass-through entities like Sub Chapter S corporations.

The likelihood that Biden will be able to make tax-related changes greatly hinges on the outcome of the Jan. 5 Senate runoff in Georgia, which will determine whether the Republicans lose or maintain their majority, said Raymond Haller, tax partner at Grassi in New York.

"Unfortunately, we have to do everything by Dec. 31, not knowing what the results are going to be five days later," he said.

There is a case to be made for some contractors to accelerate income and increase their tax liability for 2020 if they believe that tax rates will rise in 2021 under a Biden administration, Haller said. If that's the strategy, then they should also postpone big purchases until next year as a way to offset those potentially higher tax rates. The idea is to pay more in 2020 taxes but at a lower rate than is expected to go into effect for the 2021 tax year.

CARES Act and PPP ramifications

The Coronavirus Aid, Relief and Economic Security Act, which Congress passed in March of 2020 in order to alleviate some of the burdens caused by the pandemic, also created some tax benefits. According to Warren Hennagin, Marcum's California construction services leader, they include:

- More opportunities to carry net operating losses back to previous tax years.
- The ability to deduct more business interest.

- Qualified improvement property eligible for 100% bonus depreciation retroactive to 2017.
- Employer portion of Social Security deferrable to 2021 and 2022.
- A refundable payroll tax credit equal to 50% of qualified wages.

The CARES Act also established Payroll Protection Program loans through the Small Business Administration. If businesses spent the loan proceeds on qualified expenses — i.e. payroll, rent and utilities — then the PPP loans are forgivable. Portions of the loan money spent on other expenses must be paid back at s 1% interest rate.

However, the IRS has issued guidance that expenses paid with the forgiven proceeds are not deductible, which will potentially create bigger tax bills for some contractors.

Accounting professionals, said Ceschini, assumed those expenses would be a write-off. The new guidance "is not in the spirit of how the accounting profession understood it."

In order to change that and potentially make those expenses deductible, said Barry Fischman, Marcum's New England construction services leader, Congress would have to pass legislation addressing the issue, but that hasn't happened yet.

Research and development credit

More construction companies are becoming eligible for the federal research and development tax credit, Fischman said, as they develop their own innovative processes and products. This credit is advantageous because it is dollar-for-dollar.

"Payroll typically drives the credit, and contractors should be inquiring whether or not they have eligible expenses to generate those credits," he said.

As a general business credit of between 6% and 12% of qualifying expenditures, the R&D credit can provide cash savings to enable reinvestment and growth, according to Cole Marr, research and development director at California accounting firm Sensiba San Filippo.

Unfortunately, many construction companies are performing R&D that qualifies for a credit in the eyes of the IRS but don't realize it, due a lack of awareness and common misconceptions, Marr said. Possible activities in the construction industry that can be considered include:

- Development of new, improved or more reliable products, processes or techniques.
- Design improvements for LEED or energy-efficient projects.
- Development of a unique assembly or construction methods and processes.
- Experimentation with new building materials.
- Developing or improving construction equipment.
- Any project that requires an extra level of testing or certification upon completion.

Cash is king

The ultimate decider, however, of what tax rules contractors should take advantage of is their cash position, Ceschini said. For example, if a contractor needs money to make payroll before the end of the year, it doesn't make sense for it to defer the collection of invoices into 2021.

Ceschini said his clients have done well despite the challenges presented by COVID-19. On the other hand, the backlog for some is shrinking, and many haven't had as much luck winning new projects as they have in the past.

The construction industry also tends to lag other sectors when it comes to economic downturns, so that only adds to the layers of uncertainty as businesses move into 2021, which makes cash preservation even more important.

"You run a company with cash," he said.