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Tax Methods & Credits Opportunities for Contractors

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I am a Construction and EBP Partner with more than 20 years of experience servicing construction clients. I also lead our national Heavy Civil Construction Practice and the Taft-Hartley Employee Benefit Plan Service line which gives me a unique understanding of the innerworkings of fringe benefits and governmental reporting requirements.

I have extensive experience with various methods of accounting, including percentage of completion, completed contract, cash method, and optimizing the tax accounting rules to enhance my clients cash flow. In addition, I have experience with corporate succession planning, strategic corporate planning, talent retention experience in the construction industry, and personal balance sheet planning.

I often speak at CFMA national and local events and at other industry conferences, such as the International Foundation of Employee Benefit Plans (IFEBP) national conference on benefit trends and regulations. As a Certified Construction Industry Financial Professional, I maintain professional credits each year in knowledge of the construction industry. Active in the industries I serve, I belong to the AICPA, the MICPA, the International Foundation of Employee Benefit Plans, the Lansing chapter of the Construction Financial Management Association (board member),

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I am a tax senior manager with twelve years of experience. My background includes managing engagements for companies in the service, construction and real estate industries. I have experience working with a variety of different ownership models, from private equity to owner-managed businesses. My clients appreciate my responsiveness and proactive approach. I work to provide additional value through tax planning, including accounting method changes, depreciation, and tax credits.

I received my B.B.A. in accounting and Master of Science in taxation from Grand Valley State University.

Fun fact: I volunteer with and am President of a local dog rescue. Our mission is to save dogs on their last day. My family has also fostered four dogs and hopefully many more to come.

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- On the surface, we're one of the nation's largest audit, tax, consulting, and wealth management firms.
  - But dig deeper, and you'll see what makes us different:
    we're a people-focused firm with a world-class culture delivering unparalleled client service.
- We are celebrating our 25th year on the Fortune's Best Companies to Work for List.
- We serve more than 600 clients in the construction industry, and we're home to more than 350 professionals who have made serving construction clients their career focus.

General Tax Updates

Tax Depreciation

- Bonus depreciation drops to 60% in 2024
  - Down to 40% in 2025

- Section 179
  - Maximum expense deduction is $1,220,000 for 2024, and investment limit is $3,050,000 – reduces section 179 dollar for dollar by the amount of excess investment.

What is cost segregation?

Cost Segregation: segregating facility construction costs into the various tax depreciation (asset) classes.

- Strategic tax-planning tool used to accelerate depreciation deductions and lower current tax liability.
- The optimum time for a cost segregation study is the year the building is placed in service.
- However, you can claim missed depreciation on assets acquired as far back as 1987 without amending prior tax returns with IRS Form 3115.

Allows you to take bonus depreciation.

- Move from one piece of 39-year property to multiple pieces of shorter class life property.

Accelerates depreciation deduction ➔ lowers taxable income + time value of money = $$$$$$$.

Prepaids

The 12 Month Rule

- Allows for the deduction of a prepaid expense in the current year if the right or benefit paid does not extend beyond the earlier of 12 months from the date the prepayment is made or the end of the taxable year following the taxable year in which the payment is made.
    - Examples: insurance, rebates and licenses

- A method change is required to be able to accelerate prepaids if you are not already on this method.

Accrued Wages

- Accrued wages and payroll taxes can be deducted if it is fixed, reasonably determined, and paid within 2.5 months of year-end
    - For example, wages and payroll taxes accrued at year-end for a weekly pay period that spans Monday, December 25th- Sunday, December 31st but is paid on Friday, January 5th.

Accrued Bonuses and Commissions

- Accrued bonuses and commissions deducted if it is fixed, reasonably determined, and paid within 2.5 months of year-end
  - The bonuses awarded are for services that have already been performed.
  - The bonus pool is driven by either: 1) a formula that is fixed prior to December 31st, or 2) a resolution by the board of directors or compensation committee that is made before December 31st.
  - The total amount to be paid to employees will be determined prior to year-end, but the amount to be paid to each individual employee will not be determined until the bonuses are paid.
  - To be eligible for the bonus, an employee must remain employed on the date that the company pays the bonus. Any amounts that would have been paid to an employee who is not employed on the date the bonus is paid will be reallocated to the other employees.

Exceptions to Accrued Compensation Deductions

- Compensation deductions are only allowed when the employee reports the payment of income (no acceleration allowed)
  - S corporation shareholders
  - LLC members and partners
  - More than 50% C corporation owners
  - Related parties- spouse, child, brother, sister, parent or grandparent

Rules to expire after 2025

- Top income tax rates are set to increase from 37% to 39.6%
- SALT deduction cap of $10,000 is set to expire
- Standard deduction set to decrease
- QBID to expire
- Bonus depreciation decrease by 20% each year until it is eliminated in 2026
    - 2023 – 80%
    - 2024 – 60%
    - 2025 – 40%
    - 2026 – 20%
    - 2027 & beyond – 0%
- What is in a future bill? Will depend heavily on the election
- Few changes are expected during the rest of 2023 and 2024

Tax Methods for Contractors

Tax Methods for Contractors

- Percentage of Completion
- Retainage Payables
- Cash Method for Large Contractors
- Pay-If-Paid Subcontractor Payables
- Small Contractor Methods
  - Cash Method
  - Completed Contract
- Exempt Contracts
  - Residential Method (70%/30%)
  - Home Contract (Completed Contract)

Percentage of Completion

A method of accounting for long-term projects in which revenue and expenses are recognized based on the percentage of work they have completed during the period.

- The current income and expenses are compared with the total estimated costs of a project to determine the tax liability for the year

There are two main conditions for the use of the percentage of completion method.

- First, collections by the company must be reasonably assured
- Second, the company must be able to reasonably estimate costs and the rate of project completion.

Retainage

If you withhold retainage from subcontractors, you may be able to defer some of your taxable income to future years.

- This opportunity stems from the way retainage payable is treated under the PCM of accounting.
- You can exclude retainage from the PCM calculation until it becomes a "fixed and determinable" liability and, therefore, must be treated as an incurred cost.
  - Under IRS rules, a liability must be recognized by an accrual-basis taxpayer when:
    - All events have occurred to establish the fact of the liability.
    - The amount of the liability can be determined with reasonable accuracy.
    - Economic performance has occurred.

Cash Method for Large Contractors

- **Allows taxpayer to change overall method of accounting to the cash method.**
  - Long-term contracts are still calculated under percentage of completion
  - Definition of long-term contract under IRC Sec 460 = "… **if such contract is not completed within the taxable year in which such contract is entered into"**
- **Can be used as a cash deferring strategy as the large book/tax difference functions like a quasi-permanent difference.**
- **Client Types:**
  - Specialty Contractors
  - Contractors with seasonality

Implementing Method / Challenges

1. **Advanced Consent 3115 Tax Account Method Change Required**
   - Requires 481(a) Adjustment
   - Needs to be submitted to IRS for review prior to YE for the method to be retroactively used at start of year. IE. 2024 3115s due 12/31/2024.
   - User Fee Required (Consolidated Groups can file together as one)
     - $11,500 for 2023 via electronic payment
2. **Creates need for a Book WIP and a Tax WIP to be kept separately by either the client or PM.**
3. **Additional year-end planning challenges**

What to look for…

- Vendor payment terms that are shorter than their typical cash collection cycle
- Ways to maximize tax benefit
  - Have a plan to close contracts and fully bill before year end
  - Pay as many payables by year-end to get credit for expenses
- Inventory
  - Make sure this is addressed in the 3115

Pay-If-Paid Subcontractor Payables

- **Need:**
  1. Explicit "Condition Precedent" in the subcontract
  2. Operate in States that allow Pay-If-Paid contracts
- **Allows 100% exclusion of Subcontractor Payables at 12/31 or YE for the IRC Section 460 Calculation.**
  - Payables come out of the numerator of the calculation, thus changing tax percentage of completion, and generate a book/tax difference.
- **Can be used as a cash deferring strategy as the large book/tax differences function similar to a quasi-permanent difference.**
- **Client Types:**
  - General Contractors
  - Specialty Contractors / Contract Manufacturers

Standard Cost-Cost POC w/ no methods

	ASC740 POC Calculation							
	Contract				Job to Date			
	Contract Value	Estimated Costs to Complete	Estimated Gross Profit	Gross Profit Percentage	Revenue	Cost	Gross Profit	Percent Complete
Financial	10,000,000	8,500,000	1,500,000	15%	2,352,941	2,000,000	352,941	23.53%
PIP Subcontractor Payables						-		
Revenue Adjustment					-			
Tax	10,000,000	8,500,000	1,500,000	15%	2,352,941	2,000,000	352,941	23.53%
Difference					-	-	-	
							ASC740 deferral	

Standard Cost-Cost POC w/ PIP

	ASC740 POC Calculation							
	Contract				Job to Date			
	Contract Value	Estimated Costs to Complete	Estimated Gross Profit	Gross Profit Percentage	Revenue	Cost	Gross Profit	Percent Complete
Financial	**10,000,000**	**8,500,000**	**1,500,000**	**15%**	**2,352,941**	**2,000,000**	**352,941**	**23.53%**
PIP Subcontractor Payables						(1,000,000)		
Revenue Adjustment					(1,176,471)			
Tax	**10,000,000**	**8,500,000**	**1,500,000**	**15%**	**1,176,470**	**1,000,000**	**176,471**	**PIP**
Difference					(1,176,471)	(1,000,000)	(176,470)	
							ASC740 deferral	

Pay-If-Paid vs Pay-When-Paid Contracts

- **Pay-If-Paid:**
  - Key clause here is the idea of a “Condition Precedent”
  - General Contractor only pays subcontractor IF paid by owner
  - Risk of loss is shared between the Subcontractor / General contractor for each part of contract

- **Pay-When-Paid:**
  - No condition precedent exists, but the law function is a “timing mechanism”
  - General contractor pays WHEN paid
  - Risk of loss is shared between the General / Subcontractor

Implementing Method / Challenges

1. **Advanced Consent 3115 Tax Account Method Change Required**
   - Cut off
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   - User Fee Required (Consolidated Groups can file together as one)
     - $11,500 for 2023 via electronic payment
2. **Creates need for a Book WIP and a Tax WIP to be kept separately**
3. **Where you do business is important because some states do not allow Pay-If-Paid.**

What to look for…

- Do you subcontract much of your work or self-perform the work?
  - If yes, then Pay-If-Paid or retainage payable could provide big book/tax benefit.
  - If no, there are still some opportunities to create some benefit via other methods.
- Have you reviewed the standard subcontract recently?
  - Is their contract Pay-If-Paid or Pay-When-Paid?
- What states do they do business in?
  - Certain states do not allow Pay-If-Paid contracts to be used.
    - CA, NC, WI, & NY to name a few.
- Are you an ESOP?
  - While the federal benefit is likely not worth the initial investment, depending on the state footprint, there could be some tax dollars to be saved.

Small Contractor Methods

- Small taxpayer
  - Gross receipts threshold – $30 million for 2024
- Cash Method
  - Recognizes revenue when payments are received and expenses when they are paid
- Completed Contract
  - Revenue and costs of contracts are not recognized for tax purposes until the contract is completed (over 95% complete)

Exempt Contracts

Home Contract (Completed Contract)

- Recognize revenue and expenses when the contract is complete.
- a contract is completed under the completed-contract method at the earlier of
  - (1) when the subject matter of the contract is used by the customer for its intended purpose and the taxpayer has incurred at least 95% percent of the total allocable contract costs attributable to the subject matter or
  - (2) upon final completion and acceptance of the subject matter of the contract.

Exempt Contracts

Residential Method (70%/30%)

- Residential construction contracts are eligible to use percentage of completion capitalized cost method (POCCCM) (Sec. 460(e)(5)).
- If required to use POC, 30% of contract is exempt.
- Definition same as home construction, except for “more than four dwelling units.”
- Average stay is more than 30 days.
- Exempt portion uses “normal” (elected) method of accounting.

Implementing Method / Challenges

1. Advanced Consent 3115 Tax Account Method Change Required
   - Cut off
   - No 481(a) Adjustment
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Tax Credits

What is the R&D tax credit?

- Dollar-for-dollar reduction of tax liability
  - Non-refundable tax credit
  - Credit carries back 1 year and forward 20 years
  - Federal benefit is approximately 6%-8% of qualified expenses

- State Credits Available
  - Common states: OH, IL, IN, CA, TX, GA
  - Benefits vary by state

- Startups may qualify for a payroll tax offset

R&D Credit: Qualified Research Expenses

Section 174: Capitalization of research & experimental expenses

- Notice 2023-63
  - Released September 8, 2023
  - Announced IRS' plan to issue proposed regulations on Section 174
  - Does not repeal or pause required Section 174 capitalization
  - Provides insight into how IRS is viewing several issues (but not all issues)

Qualified vs. Non-Qualified Activities

Qualified	Non-Qualified
Fixed Fee	Time & Materials
Design Layouts/MEP Systems	Installation
Temperature Studies	Environmental Studies
Design-Build	Plan & Spec
CAD Modeling/Simulations	Physical Construction
Design of Temporary Systems	
New Construction Method or Process	
New Building Materials	
Green Building and Sustainable Designs	

Section 174: Capitalization of research & experimental expenses

- Notice 2023-66
  - The interplay of long-term contracts under the percentage-of-completion rules of Section 460 and 174 capitalization
  - Treasury's current position that the PCM method doesn't override the general requirement to capitalize and amortize R&E expenses and that only amortization of R&E expenses are included in the numerator of the completion factor.
  - The Notice provides that Treasury plans to issue regulations that would require taxpayers to include the amortizable portion of Section 174 costs in the numerator of the completion factor.
  - The Notice didn't conclude on what amount to include in the denominator and requested comments from the public on that issue.

  - Plante Moran- navigating section 460 long-term contracts with section 174 capitalization rules

Section 174: Capitalization of research & experimental expenses

Scenario Number 1

- Immediately deduct R&E expenses
  - A taxpayer takes the position that section 460 takes precedence over the section 174 capitalization and amortization rules
  - This scenario conflicts with Notice 2023-66

Scenario Number 2

- R&E amortization in numerator of completion factor
  - A taxpayer takes the amortized R&E expenses for the year and includes them in the numerator of the completion factor, while the total R&E expenses are included in the denominator.
  - Scenario No. 2 is a more favorable result in year one because fewer expenses are recognized
  - This scenario is consistent with Notice 2023-66

Section 174: Capitalization of research & experimental expenses

- Scenario Number 3
  - R&E amortization in numerator and denominator of completion factor
    - Taxpayer would include only the amortized R&E expenses for the year in the numerator of the completion factor
    - The denominator includes only the R&E expense amortization anticipated to occur during the life of the contract.
    - This scenario is consistent with Notice 2023-66

    Scenario Number 4
  - R&E amortization in numerator of completion factor
    - R&E expenses are capitalized and amortized to determine the expenses deducted during the year, but the completion factor is determined by disregarding that capitalization.
    - This scenario conflicts with Notice 2023-66

Fuel Tax Credits

- Inflation Reduction Act extended fuel tax credits through 2024
  - Allows businesses to reduce their taxable income dollar for dollar based on using specific types of fuel costs
  - Biodiesel and renewable diesel credit
  - Biodiesel and renewable diesel mixture credit

Inflation Reduction Act

Expanded credits & incentives

- Manufacturing credits
- Electricity credits
- Energy efficient equipment

What did this create?

- Ecosystem of credits and incentives supporting green energy ($500 billion of new federal spending)
- Aimed toward improving economic competitiveness, industrial productivity, and innovation
- Third piece of legislation accumulating $2 trillion of federal spending over the next 10 years

IRA Credits and Incentives

	Production credits	Investment credits
Manufacturing	• Advanced Manufacturing Production Credit: Sec. 45X • Energy Efficient Home Credit: Sec. 45L	• Qualifying Advanced Energy Project Credit: Sec. 48C
Electricity production & storage	• Electricity Produced from Certain Renewable Resources: Sec. 45 • Clean Electricity Production Credit: Sec. 45Y, applies in the future	• Energy Credit: Sec. 48 • Clean Electricity Investment Credit: Sec. 48E, applies in the future
Hydrogen production & production/use of other fuels	• Clean Hydrogen: Sec. 45V • Alcohol, Etc. Used as Fuel: Sec. 40 • Biodiesel and Renewable Diesel Used as Fuel: Sec. 40A • Sustainable Aviation Fuel Credit: Sec. 40B • Clean Fuel Production Credit: Sec. 45Z, applies in the future	
Clean Vehicle & Alternative Refueling Property		• Qualified Commercial Clean Vehicle: Sec. 45W • Alternative Fuel Refueling Property Credit: Sec. 30C • Clean Vehicle Credit: Sec. 30D • Previously-Owned Clean Vehicles: Sec. 25E • Nonbusiness Energy Property Credit: Sec. 25C • Residential Clean Energy Credit: Sec. 25D
Other	• Carbon Oxide Sequestration: Sec. 45Q	• Energy Efficient Commercial Buildings Deduction: Sec. 179D • Cost Recovery of Qualified Facilities: Sec. 168

IRA Credits and Incentives

Alternative Energy Tax Investments

- The IRA enhanced and increased certain credits for investors looking to take advantage of purchasing and providing alternative energy for certain locations within the U.S.
- You get Bonus Depreciation and Tax Credit
  - Must met certain requirements

Prevailing wage & apprenticeship hour requirements

Prevailing wage	Apprenticeship hours
• Requires workers constructing facilities to be paid at least a prevailing wage	• Requires a specified percentage of total labor hours to be completed by qualified apprentices
• Extends to contractors and subcontractors	• Total labor hours include contractors and subcontractors
• Wage data by role and county are maintained on sam.gov by the Department of Labor	• The required percentage phases in over time: 10%, 12.5% and 15%
• Will generally apply to facilities where construction begins after January 29, 2023	• A good-faith exception is available if apprentices are formally requested but either denied or not fulfilled
• Key implications: Will need to account for this in contracts; higher upfront costs for long-time benefits	

Prevailing wage & apprenticeship hour requirements

Planning

Are you required to meet these standards based on the size of your project?

Does your contractor have sufficient understanding of these requirements, and will they provide documentation to support?

Do your contracts/agreements protect you if requirements are not met or documentation is not provided?

Documentation

IRS FAQ lists items below to document compliance with these requirements:

Payroll records reflecting hours worked in each wage class along with actual wages paid to each worker constructing the facility.

Copies of written requests for apprentices or agreements with apprenticeship programs.

Records reflecting the daily ratio of apprentices to journey workers, including payroll records.

State Tax Updates

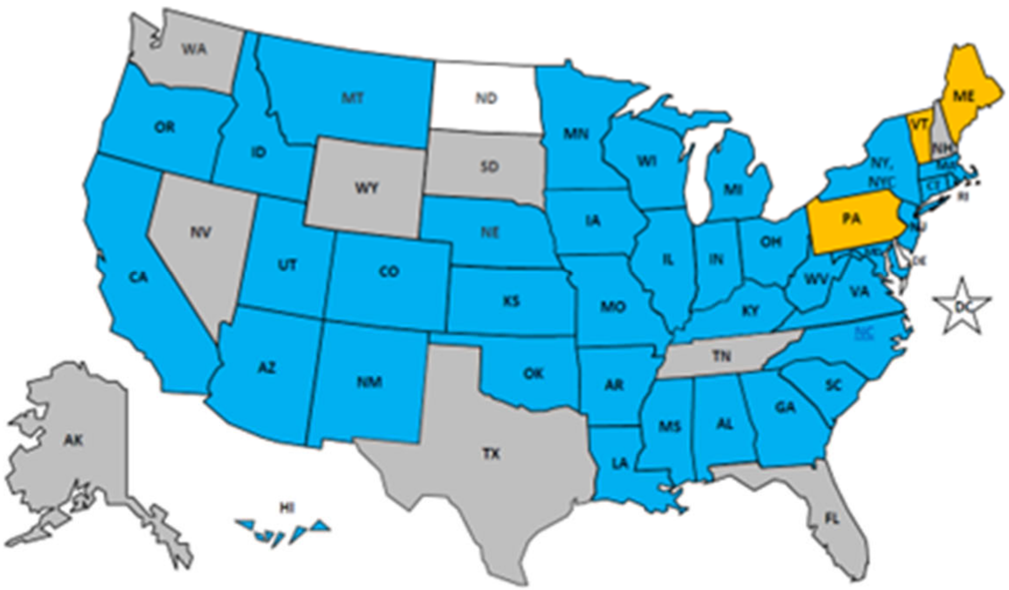
Pass-Through Entity Taxes

- Election for pass-through entities (partnerships and S-Corporation) to elect to pay state income taxes at the entity level (“PTE Taxes”)
- Workaround for deduction limitation of individual state taxes at $10,000 I claiming itemized deduction
- Most states have a PTE Level Tax

Pass-Through Entity Taxes

States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax

As of August 10, 2023



- 36 states (& 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted:

  AL, AR[1], AZ[1], CA, CO[3], CT[4], HI[2], GA[1], IA[1], ID, IL, IN[1], KS[1], KY[1] (& KY) ,LA, MA, MI, MD, MN, MO[1], MS[1], MT[2], NC[1], NE[3], NJ, NM[1], NY, OH[1], OK, OR[1], RI, SC, UT[1], VA, WI, WV[1], and NYC[1]

  [1] Effective in 2022
  [2] Effective in 2023 or later
  [3] Retroactive to 2018
  [4] Mandatory 2018-2023, elective starting 2024

- 3 states with proposed PTE tax bills:
  ME - LD 1891 introduced (session ended)
  PA – SB 659 and HB 1584 introduced

  VT – SB45 passed Senate, in House (session ended)

- 9 states with no owner-level personal income tax on PTE income:
  AK, FL, NH, NV, SD, TN, TX, WA, WY

- 3 states with an owner-level personal income tax on PTE income that have not yet proposed or enacted PTE taxes:
  DC, DE, and ND

AICPA

Questions? Happy to help!

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