CONSTRUCTION BUSINESS OWNER

Exploring the Trifecta of Tax Changes

How contractors can leverage pandemic relief, new tax laws & untapped opportunities

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When you're applying the same business practices day in and day out, there's not much room for change. Real change often takes a different approach. With a new administration in Washington come new tax laws, and construction businesses should take the time to digest them. Some of the new laws were a response to the pandemic, and others represent a shift in policy. Viewed in conjunction with tax deferrals and other strategies in existence for years, new opportunities to help keep money invested in day-to-day operations and manage cash flow needs are now available.

Tax Credits

Research & Development

The Research and Development (R&D) tax credit has been available for more than 40 years, yet it is often underutilized. Contractors who create or improve a product or process in the course of their business can benefit from the credit. A number of industry-specific activities, including innovative design build and innovative delivery methods, open the door for credits that could amount to a dollar-for-dollar reduction in tax liability for certain R&D expenses. In addition to the federal R&D tax credit, many states offer R&D tax credits of their own.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) is a federal tax incentive that provides a credit to contractors for hiring employees from target groups that consistently face barriers to employment. These groups include qualified veterans, qualified ex-felons and recipients of supplemental security income (SSI) benefits. Many contractors could benefit from this tax credit and should establish systems within their hiring departments that lead to new opportunities to hire overlooked talent.

Employee Retention Tax Credit

The Employee Retention Tax Credit (ERTC), established by the Coronavirus Aid, Relief and Economic Security (CARES) Act, is aimed to encourage employers to retain their workforce through the economic challenges caused by the COVID-19 pandemic. The ERTC is available for part of 2020 and 2021.

For 2021, the ERTC was significantly modified to allow businesses and contractors that received a first and second round of Paycheck Protection Program (PPP) loans to be eligible for the ERTC, so long as the same wages were not used for the ERTC and PPP. Contractors can qualify for the ERTC in one of two ways: via the governmental order rule, where business operations were fully or partially suspended by a governmental mandate, or via a significant reduction in gross receipts. Below is a summary of certain rules under the ERTC for 2020 and 2021:

- *Gross Receipts*
  - For 2020, the ERTC gross receipts test is met if gross receipts were down by 50% in a 2020 quarter from a comparable 2019 quarter.
  - For 2021, the ERTC gross receipts test is met if gross receipts were down by 20% in a 2021 quarter from a comparable 2019 quarter.
- *Maximum Credit Available*
  - For 2020, the ERTC is a 50% tax credit on qualified wages, up to $10,000 per employee. Therefore, the maximum credit per eligible employee is $5,000.
  - For 2021, the ERTC credit was increased from 50% to 70%. In addition, the credit is allowed per employee per quarter. Therefore, the maximum credit is $7,000 per employee per quarter (for the first three quarters of 2021).
- *Qualified Wages*
  - In 2020, for employers with 100 or fewer employees, wages qualified for the credit if they were paid to employees, whether or not the employees were providing services. For employers with more than 100 employees, only wages paid to employees who were not providing services qualified.
  - In 2021, the ERTC was modified to increase the 100-employee limit to 500 employees. Therefore, if the employer had 500 or fewer full-time employees in 2019, wages paid to employees qualify regardless of whether the employees provided services.

Tax Deferrals

The IRS specifically addresses tax matters and construction industry issues within Internal Revenue Code Section 460 for long-term contracts.

Although construction contract rules can be complex, this code section offers tax planning opportunities that can help construction contractors save on long-term contracts. Tax deferrals contractors should consider include:

- *Small contractor's exemption* — A contractor is exempt from the percentage of completion method if the company estimates the contract will be completed within a two-year period and the taxpayer's average annual gross receipts for the three previous tax years are less than $26 million.
- *Home construction contracts* — A home construction contract is any contract where at least 80% of the estimated costs are expected to be attributable to the construction of dwelling units in a building containing four or fewer dwelling units. Contracts for improvements to real property related to these dwelling units are also included. For example, if a contractor is building single-family homes or townhomes that contain four or fewer dwelling units, the contractor is not required to report income on the percentage of completion method for that contract. Income then may be reported on the completed contract method.

- *Residential contracts* — A residential contract is similar to a home construction contract, except the building is defined as containing more than four dwelling units. This does not include hotels, motels, or establishments used on a transient basis. For residential contracts, a 70/30 hybrid method is allowed, meaning that 70% of the contract is reported on the percentage of completion method and 30% of the contract is allowed for an exempt method, such as the completed contract method. Some examples of residential contracts include general contractors and sub-contractors working on apartments, condominiums, dorms, assisted living facilities, barracks and prisons.
- *Election to use the 10% method* — If the contractor is required to use the percentage of completion method, there is an election that allows the contractor to defer income if, at the end of the year, the contract is less than 10% complete.

Qualified Business Income Deduction

Qualified Business Income Deduction, also known as 199A, was included in the Tax Cuts and Job Acts of 2017 (TCJA).

It allows eligible business owners to deduct up to 20% of their qualified business income (QBI) for pass-through entities, such as partnerships and S-corporations.

When the law first passed, contractors were uncertain if they qualified for the deduction. However, since then, IRS regulations clarified that their business does indeed qualify.

This deduction is meant to provide tax relief to businesses not benefitting from the tax rate reduction provided to C-corporations under the TCJA. C Corporations had their tax rate cut from 35% to 21%, while individuals received a modest reduction of two to four percent. The QBI deduction helps even the playing field.

For individuals with income in excess of $329,800 (married filing jointly) or $164,900 (single), for 2021 the deduction is limited to the greater of 50% of W-2 wages or the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property (UBIA) held in the contractor's business. Wages are defined as total wages paid during the calendar year, which are subject to withholding, elective deferrals, and deferred compensation. This is generally Box 5 of your W-2 or Medicare wages.

SALT Cap Workaround

Under the TCJA, which affected tax years beginning in 2018, the state and local tax (SALT) deduction was capped at $10,000 per year on Federal Schedule A for taxpayers who itemize. States have been trying to find a legal workaround to alleviate this SALT cap.

IRS Notice 2020-75 gave the green light for a SALT cap workaround that enables pass-through entities to deduct entity-level SALT payments as business expenses in place of being capped at the $10,000 per year on federal Schedule A for taxpayers who itemize.

The pass-through entity would then pass on to the ultimate taxpayer a credit of most of the business tax paid. That credit can be applied on their personal tax return.

Not all states have conformed to the workaround, and how to incorporate it varies by state. Some states have certain deadlines and required elections. Each state's income tax laws should be reviewed carefully.

Start With Proactive Planning

Tax planning tools for contractors abound, resulting from a trifecta of change — pandemic relief, new tax laws and untapped opportunities to leverage existing tax laws. Take the opportunity now to review your tax planning strategies with your tax advisor to make the most of 2022. ▲

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