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Tax planning

What contractors should know about bonus depreciation

As projects heat up, construction company owners often find they must buy additional equipment or other assets to ensure project success and remain competitive. Because return on investment for high-dollar purchases can take years, finding the right tax deductions to help offset costs is critical to staying in the black.

The good news is that, thanks to a new and improved version of the bonus depreciation tax break, many businesses buying qualified assets in 2018 will be able to immediately deduct much more than in recent years for their capital expenses.

The important stuff

As you may recall, the Tax Cuts and Jobs Act (TCJA) was signed into law in December 2017. Among its many changes, the law substantially increased the first-year bonus depreciation deduction from 50% to 100%.

You can apply bonus depreciation to the cost of vehicles, machinery, equipment, computer systems, software, office furniture and other assets that have a useful life of 20 years or less and that are purchased under certain conditions. (In other words, they can't be a gift or inheritance or bought from an ancestor or descendant, such as a child, parent, grandparent or grandchild.)

Another important change is that the deduction is now allowed for both new and used qualifying property. In the past, businesses couldn't claim bonus depreciation for purchases of used property.

Businesses also can claim bonus depreciation for "qualified improvement property," which is any eligible improvement made to the interior portion of a nonresidential property — if the improvement is placed in service after the date the building is placed in service. Similar to previous years, the following three improvements don't qualify: 1) enlargement of a building, 2) elevator or escalator work, or 3) changes to the internal structural framework of a building.

If your business-related purchases don't qualify for first-year bonus depreciation, the Section 179 deduction provides similar benefits. (See "Section 179 expensing and the TCJA" on page 3.)

A look back — and forward

In nearly every year since 2001, businesses have been able to immediately deduct a percentage of the cost of eligible property during the first year it is placed in service — with the remaining cost deducted using regular depreciation methods, the Sec. 179 deduction, or a combination of regular depreciation and the Sec. 179 deduction. (See "Section 179 expensing and the TCJA" on page 3.)

This became known as "bonus depreciation." It was designed as a tax incentive to help stimulate the economy as well as provide tax relief for small to midsize businesses in need of

equipment. Although the bonus depreciation deduction expired between 2005 and 2007, it returned in 2008. Percentages have ranged from 30% to 100% over the years, but the deduction hasn't been at 100% since the 2011 tax year.

After the Protecting Americans from Tax Hikes (PATH) Act was passed in late 2015, the bonus depreciation deduction, which at the time was 50%, was on the road to being phased out yet again. The percentage under the PATH Act was scheduled to decrease to 40% in 2018 and 30% in 2019 before disappearing (with certain exceptions) completely in 2020. The TCJA, however, breathes new life into the deduction, ensuring it will remain for several more years.

Under the new law, 100% bonus depreciation is available for assets placed in service after September 27, 2017, and before January 1, 2023. Then bonus depreciation is scheduled to be reduced as follows:

- 80% for property placed in service in 2023,
- 60% for property placed in service in 2024,
- 40% for property placed in service in 2025, and
- 20% for property placed in service in 2026.

For certain assets with longer production periods, the above dates are delayed by one year. For example, 100% bonus depreciation applies to long-production-period property placed in service in 2023 and is reduced to 80% for such property placed in service in 2024.

Complicated business

Claiming depreciation deductions can get complicated — especially with the recent tax law changes. To reap the full benefits, contact your CPA to discuss your construction company's 2018 capital improvement purchase plans, as well as plans for future years.

Section 179 expensing and the TCJA

Like bonus depreciation, Section 179 expensing allows businesses a large deduction for certain business assets in the year they're placed in service, rather than depreciating them over a longer period. It encourages companies to stay competitive by investing in needed equipment and writing off the cost on their tax returns. This deduction is tailored for small to midsize businesses, because it has a spending cap that larger businesses often will exceed.

Under previous tax law, the maximum deduction was $510,000, with a $2.03 million phaseout threshold for total equipment purchased in a year. Since this law is still applicable on your 2017 return, this means that you can deduct the full cost of qualified purchases (up to $510,000 for total asset purchases for the year) until $2.03 million is reached. Once that happens, the deduction decreases on a dollar-for-dollar basis and disappears entirely at $2.54 million.

The Tax Cuts and Jobs Act (TCJA) essentially doubles the deduction to $1 million while increasing the phaseout threshold to $2.5 million. At $3.5 million, the deduction disappears. These amounts will be indexed for inflation after 2018.

Nearly all types of business assets qualify for Sec. 179 expensing, including equipment, vehicles exceeding 14,000 pounds (vehicles weighing more than 6,000 pounds may be eligible for a partial Sec. 179 deduction), computers, software, and property attached to your building that's not a structural component (such as large manufacturing tools and equipment). The TCJA also expands the definition of qualified real property to include the following improvements to nonresidential real property: roofs; heating, ventilation, and air-conditioning equipment; fire protection and alarm systems; and security systems.

Remember the BAA when working on public projects

Although the Buy American Act of 1933 (BAA) isn't new, a presidential executive order issued in April 2017 has placed the law top of mind for contractors involved in public projects. The executive order tasks public agencies to more scrupulously monitor and enforce contractor compliance with the BAA — and to minimize the use of waivers granted.

Also, as of this writing, the current administration has proposed a massive infrastructure bill. So, even if your construction company doesn't typically work on public jobs, now's a good time to remember the BAA.

Qualifying materials

The BAA applies to work valued between $3,500 and about $6.9 million. Construction contracts with values of $3,500 or less are generally considered "micropurchases" and are exempt from the law. Foreign trade agreements may supersede the BAA for contracts exceeding $6.9 million. (Note: These dollar amounts are subject to change. Check with your CPA or attorney for the latest.)

Under the law, only "domestic construction materials" can be used. A construction material is any article, material or supply brought to the construction site by a contractor or subcontractor to be incorporated into the project. Materials aren't "end products."

A construction material is considered domestic if it's manufactured in the United States and the cost of its U.S.-made components (including transportation costs and taxes or overhead) exceeds 50% of the cost of all its components. Unmanufactured materials are considered domestic if they're mined or produced domestically.

Construction materials are also considered domestic if the material is commercially available "off the shelf," meaning it's sold in substantial quantities in the commercial marketplace and used by the public for nongovernmental purposes.

Waiver matters

The BAA's requirements may be waived by the contracting agency if the customer determines that the domestic product:

- Is unreasonably expensive as compared with an identical foreign-sourced material,
- Is unavailable in sufficient commercial quantities of satisfactory quality, or
- Fails to serve the public interest.

In addition, when certain conditions are met, the BAA can be waived for eligible foreign products acquired through trade agreements between the United States and other countries.

The contractor is responsible for requesting the waiver, and it's best to do so during the bid process — before a contract is awarded. If the waiver is approved, acceptable foreign materials will be listed in the contract.

Serious consequences

General contractors are responsible for subcontractors and suppliers. So, it's important to include the appropriate language in subcontracts and supplier agreements, and to verify that these parties are using or delivering BAA-compliant materials.

The government also can terminate the contract for default and/or suspend or ban the contractor, subcontractor or supplier. In worst cases, a contractor could face a public criminal investigation and may be barred from receiving another public contract for three years.

It's important to include appropriate language in subcontracts and supplier agreements and to verify these parties' compliance.

Stringent enforcement

While the BAA hasn't changed recently, several statutes have been enacted that offer similar provisions. And, as mentioned, last year's executive order encouraged stricter enforcement of the law. Be sure to keep all this in mind should the opportunity come up to bid on a public job.

Whipping up more profitable jobs with WIP reports

Jobsites generate many things — dust, rubble, scrap metal. But they also generate a lot of information. And extracting the right financial data from an ongoing project in an accurate, timely and easily digestible manner is critical to maintaining that job's profitability and avoiding losses.

Depending on the size and nature of your construction company, you may handle job status reporting in a variety of ways. Some contractors keep handwritten notes; others call up the home office and dictate important numbers to whoever keeps the books. Usually, however, creating formalized work in progress (WIP) reports is the best way to go.

Choose your data points

There are many ways to create WIP reports, including spreadsheet programs and specialized accounting software. Whichever method you use, the report should track key data points for each project in progress, such as contract price (including approved change orders), as well as estimated total job cost and gross profit by job. It should also indicate costs incurred to date on each job and the revenues you have recognized.

Don't forget billings — a WIP report can tell you how much you've billed to date and billings in excess of earnings or earnings in excess of billings. The report can also show you the project's overall percentage of completion.

Most contractors should run WIP reports at least monthly. But some companies review them every week. *Warning:* The process requires a current, complete and accurate assessment of estimated costs to complete for each project. Otherwise, the information will be incorrect and could be misleading.

Bill by the numbers

Monitoring WIP reports closely can help you recognize revenue more accurately, monitor profitability (or lack thereof) and spot red flags. For example, say a job is 25% complete but your costs incurred to date are 40% of budget. That's not good but, thanks to your WIP report, you'll have time to investigate, make adjustments and, one hopes, get the project back on track.

WIP reports also indicate whether a job is underbilled or overbilled. Either situation is a potential red flag of cash flow trouble but, in many cases, there's a benign explanation.

For instance, underbilling (that is, billing that fails to keep pace with a job's progress) may be attributable to cost overruns, inefficient project management or sluggish billing practices. Any one of these issues can portend cash flow difficulties. But underbilling may instead reflect less troublesome circumstances, such as a large number of legitimate change orders in various stages of approval, or significant front-loaded costs that will be recovered over the course of the project.

Overbilling, on the other hand, is usually viewed as a good thing. It's generally defined as a contractor billing for contracted labor and materials before completing that work. Overbilling executed under strong management and billing practices is usually fine. It enhances cash flow and the work is done soon after invoicing.

Yet overbilling caused by substantial unrecorded costs may point to trouble down the road, because these expenses will manifest themselves eventually. Also, overbilling too much may leave you with nothing left to bill for while you're still completing the project. That's not good for cash flow. WIP reports can help you pace yourself appropriately.

Stop the fade

WIP reports can slow or stop profit fade, too. This is the gradual decline in projected gross profits over the course of a job. There are several potential causes of profit fade, including:

- Inaccurate initial estimates,
- Lax project management,
- Sloppy change order practices, and
- Unanticipated jobsite problems.

Again, the report's data, when maintained and analyzed regularly and accurately, can tip you off to discrepancies that will put a drag on profits before the project gets too far along.

Get crackin'

If you already produce WIP reports and use them to your advantage, kudos to your construction company. But if you don't, or you haven't revised or updated your methodology lately, it may be time to get crackin' on a better job-status reporting process.

THE CONTRACTOR'S CORNER

Could a CRM system help me win more jobs?

My construction company recently celebrated its 15th year in operation and, even better, business is really heating up. My concern is that, with this lengthy history and sizable client list, so much information seems to be falling through the cracks. We try to track everything through a shared spreadsheet, but it's kind of a mess. Is there a better way?

Indeed, there is. Your construction company might benefit from customer relationship management (CRM) software. Of course, you'll still need to carefully assess such a purchase in relation to your budget and any product's return on investment. But here are a few ways a CRM system could help:

Consolidate client data in one place. The basic purpose of CRM software is to organize and store customer and prospect data in one, easily accessible centralized location. This streamlines communication among employees because it eliminates the information silos that often occur when estimators have some contacts, project managers have others, and so on. As a result, everyone has access to the same, comprehensive data — no more lost time hunting down missing information!

Client data can include anything from company and contact information to project history and email exchanges to their relationship to your company (for example, long-term client vs. prospect). You can then organize these contacts into groups (for instance, by company) or into any list you see fit. This helps identify trends or client-specific requirements that may dictate which team members need to be involved in the sales process.

Create a library of past projects and bids. A CRM system can serve as a library for past projects and bids, which estimators can use to find the optimal projects to reference for a proposal. This data can also be analyzed to identify the types of jobs your company has a high percentage of winning, so you can then focus on more winnable bids.

Organize business partners. Business partners also can be added to CRM software — including general contractors, subcontractors, architects and even competitors. You can use this information during the sales process to provide staff with a complete picture of the owner, competing general contractors, relevant subcontractors, the architect and anyone else involved in the bid.

Access data from anywhere. Cloud-based CRM solutions take sharing to a higher level by allowing users to update and retrieve data on the go. Employees equipped with mobile devices can quickly find the details on a company, contract or bid — in real time, from anywhere. As a result, tasks don't get stalled and team members can oversee projects more effectively and close bids more quickly.

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Tax Law Change Allows More Freedom to Contractors

The recently-passed Tax Cuts and Jobs Act (TCJA) represents more changes to the U.S. tax law in more than 30 years, and very few industries remain unaffected. The construction industry is no exception; contractors can expect many changes to their taxes in 2018 and beyond. One of the most impactful changes will be how they account for long-term contracts.

Accounting Method Selection

How contractors account for their long-term construction projects has always been a complex topic – cash and accrual have never been the only two options. There are many more methods contractors can use, including:

- The Completed Contract Method;
- The Exempt Percentage of Completion Method;
- The Percentage of Completion Method; and,
- The Percentage of Completion-Capitalized Cost Method.

Selecting the appropriate accounting method can have a big impact on a company's financial statements. The optimized method has the potential to delay tax payments until a later year, or even to save a company taxes over time. Having the freedom to choose your accounting method is the ideal scenario for most contractors, which is why this new tax law change may be so beneficial.

The New Law

One requirement that remained unchanged with the passage of the TCJA was that all contractors are required to use the percentage-of-completion accounting method unless (1) they are deemed to be a "small contractor," and (2) their construction contract is likely to be completed within two years. What the new law *did* change was the definition of a "small contractor."

The old law

Under prior tax laws, construction companies were considered "small contractors" when their three-year average annual gross receipts were **$10 million or less**.

The new law

Under the new TCJA, construction companies are considered "small contractors" when their three-year average annual gross receipts are **$25 million or less**.

Ultimately, this change to the gross receipts threshold allows more construction companies to classify themselves as small contractors than in years past. In 2018, many contractors who had previously been considered large contractors will no longer be required to use the percentage-of-completion method of accounting. Now, they will have the freedom to choose the accounting method that works best for them and their tax position.

This new-found freedom of choosing the optimal accounting method can be a great tool for many contractors, and if you are one of the companies who will be affected, we recommend that you talk to your CPA to discuss your options. For help in determining which accounting method best suits you and your business, contact a tax professional in LaPorte's Construction Industry Group.