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BY RICH SHAVELL

2015 Tax Planning & Potential Liabilities in the Face of Congressional Inaction

It's not easy for a contractor to project tax liabilities when tax laws remain uncertain, especially for key tax provisions that expire annually. Recall that in late 2014, Congress passed and President Obama signed the "extenders" bill that retroactively reinstituted tax breaks that had expired at the end of 2013 to the end of 2014.[1]

In late 2015, it is again unclear if and when Congress will take action. At this time, several bills still have no clear determination as to what they'll contain and whether they will be enacted for 2015.

Tax Planning Process

So, what should happen before year-end in order for contractors to effectively plan for their taxes? Let's take a look at a basic tax planning process.

First, your company's tax advisor should gather basic financial results for nine to 11 months of the year. From there, develop a reasonable projection of net income (i.e., projected book or financial statement income) for the remaining months. Tax adjustments should then be applied to determine a projected taxable income and the corresponding tax for the year. The computation of the tax liability will be either at the corporate level (for C corporations) or at the shareholder or partner level (for S corporations and partnerships, respectively).

The tax adjustments reflect differences in financial income vs. the tax rules, such as the availability of accelerated tax depreciation, deferral of income based on preferable methods of reporting contractors' income, and nondeductible expenses (e.g., officers' life insurance).

Next, consider if any actions can be taken by year-end; that is, what tax provisions, if any, can be used to lower or defer taxable income, and what credits may be available to directly reduce the projected tax liability?

Key Areas Where Congressional Action May Impact Contractors

As was the case last year, Congress may extend several key tax benefits that expired at the end of 2014 to the end of 2015. Let's consider two main categories that typically impact contractors: depreciation deductions and certain tax credits.

Depreciation Deductions

Bonus Depreciation

Bonus depreciation enables a taxpayer to write off a significant portion of an asset purchased during the current year, provided it is a new asset.

For 2014, the percentage was set at 50%.[2] So, rather than depreciating an asset over its tax life (e.g., five years) and writing off 20% as an initial year tax deduction, a company can first write off a significant percentage (e.g., 50%) and apply the 20% rate to the 50% balance that has yet to be written off. This means the contractor then writes off 60% (i.e., 50% bonus applied plus 20% times the remaining 50%) rather than only 20%.

Section 179 Expensing

This permits a 100% write-off of asset purchases up to a threshold. For 2014, the threshold is set at $500,000 provided that no more than $2 million of qualifying assets were purchased during the year. Pending Congressional action, the 2015 threshold is currently at $25,000.[3]

A major advantage of the §179 expensing is that used assets purchased by the taxpayer qualify. For example, let's say a paving contractor purchases a five-year-old backhoe from a used equipment dealer. The used backhoe qualifies for §179 expensing (but would not qualify for bonus depreciation).

Section 179D Energy Deductions

These deductions permit an ordinary business deduction for a property owner who installs certain energy-efficient assets into the building.

It's important for contractors to know that certain designers can also take the deduction if the work is performed on properties owned by government jurisdictions.[4]

The three types of work that qualify are HVAC, lighting, and building envelope (e.g., roofing, windows, and shell).

The deduction is $0.60 per square foot for each segment or a maximum of $1.80 per square foot.[5] The larger the jurisdiction's property, the more likely conducting an energy certification study makes economic sense for the contractor. GCs, HVAC, electrical, roofing, engineering, and architectural entities have all taken advantage of these energy credits.

In 2015, organizations have called for[6] a broader applicability of §179D to include certain tax-exempt entities (e.g., not-for-profit health care providers) in addition to government entities.

Tax Credits

Again, assuming Congress passes another extenders bill this year, contractors should also consider the following three tax credits.

Research & Development Credit

In recent years, the research and development (R&D) credit has been amplified to enable contractors to use it for reengineering, value engineering, and process improvement. The credit could apply to a Heavy/Highway contractor developing a better process of how to lay down a concrete or paved roadway or a GC working with architects or engineers to develop a more efficient and cost effective way to build the next project.

The credit focuses on certain specific costs, notably the amount of qualified labor, testing costs, and supply costs incurred in qualified activities. In order to compute the credits, conduct a study to document the activities and cost allocations.

A general rule of thumb for contractors is that the R&D credit can equal approximately 6.5% of the qualified costs; so, $1 million in qualified costs would equal $65,000 in credit.[7]

Empowerment Zone Credit

The empowerment zone employment credit can apply to contractors performing projects in specific geographic areas and is computed based on employee wages for those specific workers who live in one of the zones.

Generally, the zones in which these employees live do not have to be the zone in which the project is located.

Contractors must first determine whether the physical locations of their projects qualify. If any do qualify, then determine if any employees live in qualifying zones. Through job costing records, the contractor can determine whether any of the potential wages were earned from work on qualified projects.

The credit is equal to 20% of the first $15,000 of qualified wages[8] paid to each employee who is a resident of certain empowerment zones and who performs substantially all employment services within the zone in a trade or business of the employer. That's up to $3,000 per qualified employee. There are also other geographic zones (such as enterprise and enterprise community zones) that contain additional tax benefits.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) applies to a percentage of first-year qualified wages for workers who meet certain criteria. For many of the categories that follow, the credit is 40% of first-year wages of $6,000, resulting in a credit of approximately $2,400 per qualified employee.[9] Some of the groups for which an employer may be able to qualify for WOTC[10] include:

- Qualified veterans
- Qualified ex-felons
- Vocational rehabilitation referrals
- Qualified summer youth employees
- Qualified nutrition assistance program benefits recipients
- Qualified SSI recipients
- Long-term family assistance recipients

Special rules, filing deadlines, and necessary documents are all required to certify each employee. In some cases, second-year wages can qualify and the 40% rate changes for certain groups. Similar to empowerment zone credits, contractors must evaluate applicability to their operation and either outsource or develop their own certification process.

Uncertainty Remains

Without these "extenders" back in the law, a contractor's basic tax planning process should shift to a "what if" scenario. The tax projection should then consider the impact with and without new legislation.

Sample Scenario

Let's say that a contractor has a significant carryover §179 expense of approximately $150,000. If Congress does not enact new thresholds, then the contractor can only write off $25,000 for 2015.

This will not even cover the approximately $80,000 of new and used assets we'll assume that the contractor acquired in 2015. Since no law is enacted in this scenario, bonus depreciation would not be available for 2015 acquisitions either.

Conversely, if the extenders bill is passed with at least a $230,000 §179 threshold for 2015, then the contractor from the example would have a write-off of the full $230,000 ($150,000 carryover plus $80,000 of assets acquired in the current year). At an approximate 40% income tax rate, this equates to a $92,000 tax reduction.

If no such law is passed, then the deduction would be $25,000 §179 plus 20% first year depreciation times $80,000 for a total write-off of $41,000. At an approximate 40% income tax rate, that equates to a $16,400 tax reduction.

Conclusion

Congress has historically continued to extend the various tax provisions, sometimes with thresholds and amounts different than previous years. This uncertainty makes it difficult to project tax liabilities and is likely to continue until Congress enacts long-term tax reform; however, that is a dialogue for a different day.

With the help of their tax advisors, CFMs can plan for the potential impact of taxes on cash flow and their tax liability if Congress does or does not take action. ■

Endnotes

1. H.R. 5771, *Tax Increase Prevention Act of 2014*.
2. IRC § 168(k).
3. IRC § 179(b)(1)(c).
4. IRC § 179D(d)(4). Also see IRB 2008-14, "Amplification of Notice 2006-52; Deduction for Energy Efficient Commercial Buildings" Sec. 3.01.
5. IRC § 179D(b)(1)(A).
6. Coalition to Extend and Improve the 179D Tax Deduction for Energy Efficient Buildings.
7. IRC § 41(a) and § 41(C)(5) and available alternative simplified credit election.
8. IRC § 1396(c)(2) and § 1396(b).
9. IRC § 51(a).
10. IRC § 51(d)(1).

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