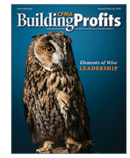

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What If There's a Downturn? Tax Implications for Contractors

Given the current strength and positive economic outlook for the construction industry, contractors often forget that cyclical periods of growth and downturn are normal and should be expected. Financial preparation for a future downturn during a strong economy can position a business to successfully weather the effects of a recession, and part of that preparation begins with understanding the tax consequences of a downturn.

Let's take a look at a few implications that can affect a contractor facing a tax loss rather than net income tax.

Qualified Business Income Deduction: Losses

While contractors doing business as pass-through entities have been enjoying the positive tax impact of the new 20% deduction for qualified business income[1] (QBI) that began in 2018 (see "The New Qualified Business Income: An Overview"[2] in the September/October 2018 issue of *CFMA Building Profits*), one aspect that is often overlooked is the effect of losses on this new tax deduction. Losses from QBI sources can reduce the current year's deduction to zero, *and* any unused negative QBI must be carried forward to the following year.[3]

For example, if Bob, a GC, has a net negative QBI of $120,000 in year one, he must carry forward the negative QBI to year two. So, in year two, if Bob has a net positive QBI of $500,000, the prior year's negative QBI carry forward reduces his year two QBI to $380,000 ($500,000 - $120,000). Instead of a QBI deduction in year two of $100,000 ($500,000 x 20%), Bob has a QBI deduction in year two of $76,000 ($500,000 - $120,000 = $380,000; $380,000 x 20%).

Any excess losses generated specifically under the QBI calculation are carried forward and negatively impact potential deductions in the following and future years until the deduction sunsets after 2025.[4] Importantly, these carry forward QBI losses must now be tracked.

Net Operating Losses

During the Great Recession and other downturns, most contractors faced large losses and cash crunches. Those current year losses were generally carried back, and in turn, prior-paid taxes could be recouped, which helped to mitigate the cash flow issue by utilizing the losses and forcing a tax refund.

However, contractors must be prepared for new tax treatment of net operating losses (NOLs). The *2017 Tax Cuts and Jobs Act* (TCJA) repealed provisions that required NOLs to be carried back two years with any excess carried forward for 20 years. Moreover, carry-over NOLs were permitted to offset up to 100% of taxable income (90% of alternative minimum taxable income). Now, NOLs for tax years ending after December 31, 2017 can only offset up to 80% of a year's taxable income[5] and can only be carried forward, albeit indefinitely.[6] The counterproductive result is *zero* infusion of cash from carrying losses back to recoup prior-paid taxes.

For example, consider that Bob's individual income tax return generates a $400,000 NOL in 2020. Under pre-TCJA rules, Bob would have first carried the NOL back to 2018 to force a cash refund, and then to 2019 where he could possibly force another cash refund. He would have then carried forward any remaining unused NOL amount for 20 more years until the NOL was totally consumed by offsetting future taxable income. However, under the TCJA, the NOL is only carried forward. In 2021, Bob has $200,000 of taxable income. As a result of the 80% limitation, Bob offsets $160,000 ($200,000 x 80%) of taxable income, and the remaining $240,000 NOL is carried forward indefinitely.

It is important to note that carry-over NOLs generated prior to December 31, 2017 are governed by pre-TCJA rules.[7] In modifying the above scenario to assume that Bob has a $200,000 NOL carry-over from 2017 (governed by pre-TCJA rules), Bob can fully utilize the 2017 NOL in 2021, thereby offsetting all of his taxable income. The full amount of the 2020 NOL would then be carried forward indefinitely. The two types of carry forward NOLs, pre-2017 and post-2017, must now be tracked from year to year.

For the typical commercial contractor, the ability to carry NOLs forward indefinitely may not be a true benefit. The same could be said for the 20-year carry forward rule under prior law. From a practical perspective, a contractor cannot continually incur losses for 20 straight years – even with the ability to defer taxable income – and be successful; at some point they must generate taxable income. The carryback provision and the corresponding ability to recoup prior-paid taxes was a far greater benefit than indefinitely extending the NOL carry forward period from 20 years.

As a direct result of the Great Recession, Congress elongated the carryback periods in 2008 and 2009, first to three years and then to five years.[8] This was done in order to permit larger tax refunds, thereby infusing the economy with a significant amount of cash. If (or when) the economy falters, Congress will hopefully again permit the carryback of NOLs and thereby reinstate the ability to recoup prior-paid taxes.

Business Loss Limitations

In addition to issues, there is a new limitation preventing the use of *current year* losses. Contractors need to be prepared for tighter limitations on deducting business losses from nonpassive activities – business activities in which the taxpayer materially participates on a regular, continuous, and substantial basis.[9] This is generally the contractor's losses from regular operations.

As mentioned, contractors tend to have large taxable losses during downturns, and in previous years there was no limitation on the amount of nonpassive losses a taxpayer could deduct in the current year. So, contractors could offset other income, such as wages and investment income, with nonpassive losses.

However, for tax years beginning after December 31, 2017, losses are subject to a new excess business loss limitation.[10] This is calculated as the excess of a taxpayer's total deductions over income attributable to trades or businesses plus $500,000 for married taxpayers filing jointly and $250,000 for all other filers (subject to an inflation adjustment).[11] The excess disallowed loss is a NOL subject to the rules previously discussed.[12]

The excess business loss limitation applies to owners of pass-through entities and is calculated at the partner or shareholder level.[13] This does not apply to C corporations, and this provision is scheduled to expire after 2025.[14]

Let's again consider Bob who is married and the sole shareholder of Builder, Inc., which is a GC and an S corporation. In 2020, Builder, Inc. has a $725,000 taxable loss. Additionally, Bob reports the following on his individual income tax return:

- Wages = $500,000
- Interest = $10,000
- Net capital gains = $100,000
- Gross Income = $610,000 before pass-through loss

Prior to the TCJA changes, Bob would have netted his pass-through loss from Builder, Inc. against his wages, interest, and capital gain for a NOL of $115,000 ($610,000 gross - $725,000 pass-through loss). Bob would have then carried the NOL back to the previous two years, potentially receiving a refund of taxes paid during the prior two years.

However, under current law, Bob's business loss would be limited by the new excess business loss limitation to an allowable loss of $500,000. The excess $225,000 disallowed loss ($725,000 loss - $500,000 statutory threshold) would then be carried forward indefinitely.

EXHIBIT 1

December 31, Year 1

Job Number	Gross Profit	Percent Complete	Deferral Net Income Effect
1-001	$150,000	8%	($150,000)
1-002	$75,000	4%	($75,000)
Total Deferral Net Income Effect			**($225,000)**

December 31, Year 2

Job Number	Gross Profit	Percent Complete	Prior Year Deferral	Deferral Net Income Effect
1-001		100%	$150,000	$150,000
1-002		100%	$75,000	$75,000
2-001	$170,000	9%		($170,000)
2-002	$70,000	6%		($70,000)
Total Deferral Net Income Effect				**($15,000)**

December 31, Year 3

Job Number	Gross Profit	Percent Complete	Prior Year Deferral	Deferral Net Income Effect
2-001		100%	$170,000	$170,000
2-002		100%	$70,000	$70,000
3-001	$80,000	7%		($80,000)
Total Deferral Net Income Effect				**$160,000**

Moreover, for the current year, Bob would have:

- Taxable income of $110,000 ($610,000 gross income - $500,000 allowable loss)
- QBI loss carry-over of $225,000

Again, importantly, the excess business losses must be tracked as an increment to the NOL carry-over.

Interest Limitations

An ancillary effect of contractors experiencing losses is that there is generally an increased need to borrow cash for operations. IRC §163(j), another TCJA enacted provision, limits the deductibility of business interest expenses for large contractors to 30% of their adjusted taxable income.[15] Large contractors are generally those with average annual gross receipts over the prior three-year period of more than $25 million.[16] The adjusted net income to which the 30% limitation is applied is generally calculated as net earnings before interest, depreciation, and amortization (EBIDA).[17] Additionally, any QBI deduction or NOL must also be added back.[18]

To illustrate, consider that in 2021, a large contractor like Builder, Inc. has an $80,000 interest expense based on $2 million of outstanding debt, including a line of credit and various equipment loans, at an aggregate and effective interest rate of 4%. Depreciation and amortization expenses for tax purposes is $150,000, and net income is actually a taxable loss of $200,000. Adjusted taxable income is $30,000, (-$200,000 + $150,000 depreciation/amortization + $80,000 interest expense). Builder, Inc.'s deductible business interest expense is limited to $9,000, (30% of *adjusted* taxable income of $30,000). The $71,000 ($80,000 interest expense - $9,000) of nondeductible interest expense is then carried forward indefinitely.[19]

And again, importantly, the nondeductible interest expenses carried forward must be tracked.

Permissible Tax Deferrals

Tax professionals often recommend various tax deferral strategies as a means to both reduce current year taxes and increase immediate cash flow (by paying less in current taxes). However, during a downturn, these tax deferrals sometimes have a reverse effect.

Let's consider one of the permissible tax deferrals available to contractors: *the 10% method*. This election permits contractors that use the percentage-of-completion method (PCM) to defer the recognition of income from long-term contracts until at least 10% of the estimated total contract costs have been incurred.[20] In a growing economy, a contractor usually generates a sufficient number of new contracts each year that are less than 10% complete to offset the recognition of deferred revenue from the prior year. Conversely, in a downturn, there may not be sufficient new contracts – and corresponding gross profit – to offset the prior year's deferral, potentially resulting in an addition to net income.

To illustrate, consider the assumed contracts analysis in Exhibit 1 on the previous page. The 10% deferral results in a $225,000 deferral "deduction" from net income in year one and an additional $15,000 deferral deduction in year two. However, in year three, when there is only one new contract that is less than 10% complete, the reversal of the prior year's deferral results in a $160,000 addition to net income for the year.

In the end, all tax deferrals "wash-out," meaning that the total aggregate net income must eventually be reported. The basic concept is that deferring income and paying taxes later is generally better than paying taxes now. The implied point here is that in year three, when the economy theoretically falters and the contractor is no longer growing, income previously deferred may have to be recognized as taxable income.

The same ramification with differing mechanics applies for all potential tax deferrals available to contractors. In addition to the 10% method, a few other tax deferral opportunities are available to contractors including, but not limited to:

- The completed contract method for those contractors meeting the "small contractor" threshold and for certain home construction contracts;
- The deferral of retainage on short-term contracts for accrual-based contractors; and
- The cash method for "small contractors."

Depending on the circumstances, the impact from previously deferred income can be far less simple than what is portrayed here, and the contractor will need to evaluate multiple variables under the new laws. So, while income deferrals generally net out less favorably when a business is contracting, there are several other tax issues that may neutralize some of this tax impact.

For example, the additional income from reversing tax deferrals may permit the deferred income to offset more of the current year's business loss thereby less loss is disallowed, as noted previously. Less loss for the current year may also permit larger contractors to compute a greater deductible interest expense under the 30% limitation. Another consideration is that less QBI loss may be carried forward, thus reducing the corresponding negative impact in the following or future years. And since NOLs can no longer be carried back, there is generally less concern about the impact to the newly generated NOL from the current year (i.e., no immediate cash impact since the loss can't be carried back).

With the TCJA's new provisions, there are multiple variables to consider and a complete analysis is necessary to truly evaluate and understand the impact of deferred income in conjunction with a current year loss.

Moreover, in addition to the tax provisions evaluated in this article, there are other – possibly less obvious – tax ramifications facing a contractor when tax losses are generated during an economic downturn.

Summary

If, or when, the construction industry faces the next downturn, CFMs should be aware that there are new and potentially complicated tax provisions impacting the contractor's tax position. Significantly, the potential to carry back current year losses to generate tax refunds is no longer available as was the case in prior years. Additionally, several new tax provisions and limitations require tracking to properly compute carry-overs into the future. ■

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Endnotes

1. IRC §199A(a)(2).
2. *www.cfmabponline.net/cfmabp/20180910/?pg=59*.
3. IRC §199A(c)(2).
4. IRC §199A(i).
5. IRC §172(a)(2).
6. IRC §172(b)(1)(A)(i) and (ii).
7. IRC §172(e).
8. *www.finance.senate.gov/imo/media/doc/Disaster Task Force FINAL 10-11-19.pdf*.
9. IRC §469(h)(1).
10. IRC §461(l).
11. IRC §461(l)(3)(A)(ii).
12. IRC §461(l)(2).
13. IRC §461(l)(4).
14. IRC §461(l).
15. IRC §163(j)(1)(B).
16. IRC §163(j)(3), which references the §448(c)(1) gross receipts test.
17. IRC §163(j)(8).
18. IRC §163(j)(8).
19. IRC §163(j)(2).
20. IRC §460(b)(5).

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