TAX STRATEGIES TO TAKE ADVANTAGE OF NOW

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Whether it be a nexus study, research and development study, or an analysis of the best method of accounting, act now before it is too late to analyze and implement the best tax strategy for your organization.

The election in November will certainly have implications on many facets of the economy, including the future tax law. The uncertain political landscape can lead to a delay in tax planning, costing an organization hundreds of thousands of dollars in potential tax savings. There has never been a more important time to be proactive with your tax planning. The Bush-era tax cuts are set to expire in January 2013, and the current law has taxes increasing for the majority of Americans, including those organizations in the construction and construction-related industries.

Fortunately, there are options available today that are specific to the construction industry and can help alleviate this potential tax burden. In this article, I will walk through four tax-saving strategies that Kirkland Albrecht and Fredrickson (KAF) is advising its clients in the construction industry to take advantage of:

1. accounting method;
2. research and development credit;
3. domestic production deduction; and
4. nexus study.

Not all of these strategies are new tax codes; some have been in existence for some time but require planning and potentially some additional filings. It has been our experience that the tax savings our clients have enjoyed far exceeded the associated costs.

Accounting method

The first strategy to consider before year-end would be your overall method of accounting. Many contractors are on the accrual method or percentage of completion method of accounting for book and tax purposes and follow IRC Section 460 for all long-term contracts. Generally, the tax law requires IRC Section 460 be applied for all long-term contracts in pass-through entities (S corporations, partnerships) with average revenues greater than $10 million and all C corporations with average annual revenues greater than $5 million. Under IRC Section 460, a long-term contract is defined as a contract lasting more than one year.

The need to diversify in tough economic conditions has led to many organizations looking for additional sources of revenue. For example, an HVAC contractor may have a division devoted to the construction of the HVAC system in commercial buildings and another division devoted to servicing these and other commercial buildings. This organizational structure would lead to some contracts spanning multiple years and many others that could be completed start to finish in the same year. The tax method of accounting chosen in this scenario can lead to very different tax results. We have seen many contractors believing they were stuck with the percentage of completion or accrual method of accounting if their revenues are greater than $10 million. If this entity was organized as a pass-through entity, that may not be the case.

If the company above was an S corporation, then there may be an option to defer taxes by changing their method of accounting to the cash basis. In the above situation, by changing the company's tax method of accounting to a cash method, the service contracts (and all other short-term contracts) started and completed within the same tax year could be treated on the cash basis. The long-term contracts are still required by Section 460(a) to be accounted for using the percentage of completion method of accounting, but the short-term contracts do not constitute long-term contracts within the meaning of Section 460(f). For additional information, see Exhibit 1.

Exhibit 1.

Percentage of Completion vs. Cash Method

ABC Contractor (accrual/percentage of completion)	
Revenues from long-term construction	$10,000,000
Revenues from short-term construction	5,000,000
Account receivable short-term construction	400,000
Book Profit	500,000
Taxable income	$500,000
ABC Contractor (cash method)	
Revenues from long-term construction	$10,000,000
Revenues from short-term construction	5,000,000
Account receivable short-term construction	400,000
Book Profit	500,000
Net income	$500,000
Cash adjustment	(400,000)
Taxable income	$100,000

Exhibit 1 is a simplified example assuming that there was no additional book-to-tax adjustments and assuming that all payables had been paid pertaining to the short-term contracts. By electing the cash basis of accounting, the contractor was able to defer the $400,000 of uncollected receivables from short-term contracts, thus reducing taxable income by $400,000.

Although the election of a tax accounting method is generally made on the initial tax return, it is not too late to change the method of accounting for tax purposes. We have made this election for many in our contractor client base and saved hundreds of thousands in taxes. This tool can lead to large tax savings, especially in the initial year. The above method can be fantastic in deferring taxable income, but it does not eliminate taxable income; it simply defers it to a future period.

Research and development

Construction companies can now consider reducing taxable income through the use of research and development credits. For years, the United States Federal Credit for Increasing Research Activities has been underutilized. With the recent expanded application of this credit, taxpayers are shocked to discover that the R&D credit is not only for high-tech, biotechnology, and software companies. Some of the best candidates for the R&D credit include construction, manufacturing, tool and die, agriculture, software development, biotechnology, structural engineering, food processing, and pharmaceutical companies. The question we get most often is: How can this be possible? The ability of construction companies to take advantage of this is due to a variety of reasons — the first being the expanded application within the federal tax law. Another influencing factor has been all of the changes within the construction industry itself since the economic downturn in 2009. Tough economic conditions have increased competition and forced contractors bidding on contracts to focus their company's resources on developing more efficient methods of performing the contract or more efficient ways of implementing the contract to help stay ahead of decreasing margins. These upfront costs could possibly qualify for the R&D credit. In addition, the increase of more design-build contracts and the use of new and improved technology on these contracts have led to more R&D credit opportunities. These new industry behaviors can be qualifying activities for R&D credit purposes. Below is a summary of the requirements necessary to meet the credit criteria.

To qualify for the R&D credit, the activities must meet four qualifications:

1. The activity must be related to the development or improvement of a business component (product or process);
2. There must be some uncertainty as to the method, capability, or design of the business component;
3. There must be a process of experimentation to overcome the uncertainty; and
4. The activities must relate to one of the hard sciences (e.g., engineering, chemistry, physics, biology, biotechnology, computer science, etc.).

While you expand your product line or improve your internal processes, you could help fund these efforts with government credits. We have assisted many clients in the construction and engineering industries in realizing large cash credits for their qualifying research activities. Regulations allow taxpayers to claim the R&D credit for all open years (typically three years), so the potential cash refund could be substantial. In addition, the time to act is now, before open tax years close and the benefit is lost.

One of the best success stories we have seen comes from a $30 million subcontractor. It was determined that this client had spent large amounts of money improving the bidding process and modifying software associated with its contracts. We were able to amend the three previous years' tax returns and take advantage of over $300,000 in tax credits. Since this company was set up as an S corporation, the shareholder was able to take these credits on his individual tax returns and receive over $300,000 in cash refunds directly.

Domestic production deduction

Another federal deduction applicable to the construction industry under IRS Code Sec. 199 is the Domestic Production Deduction, known as DPAD. Beginning in 2005, the federal government provided a deduction for businesses engaged in manufacturing and production activities to help stimulate production within the United States. For the purposes of this code section, construction companies are classified as manufacturers and are eligible for this deduction. In 2005, the deduction was limited to 3 percent of net taxable income but has risen since 2005 to 9 percent in 2012.

The formula to calculate the deduction takes numerous factors into consideration, and the more complicated the business model, the more complicated the calculation. For contractors in one line of construction, the calculation would be quite simple. Construction services in the United States, including building and renovation of residential and commercial properties, are prime candidates for this deduction.

If your company has had taxable income in the previous three tax years, you want to make sure you are maximizing this deduction in those years since 9 percent on income could be a significant tax savings.

Nexus study

To this point, we have focused on saving taxes at the federal level. The costs of state taxes, however, cannot be ignored.

State tax filings can be onerous and time consuming, and, as states have become strapped for cash, many states have been more active in claiming a portion of an entity's profits if the states believe a company may have nexus in that state. For example, a contractor may receive a notice from a state because the state sees its trucks on the road but does not see a tax return in their system. Interstate commerce is commonplace in the construction industry, and now is the time to take advantage of the potential tax benefits as well as cover the company from the potential costs associated with failure to file in all necessary states. The contractors in our client base performing work in various states have gone through a nexus study prior to year-end to identify which states may have a nexus claim. The purpose of this study is to protect the company in states it has not been filing in and also to make sure our clients are taking advantage of states with the lowest tax rates.

States use apportionment factors to determine the percentage of income attributable to their state. Each state may have a slightly different apportionment factor, but most of them use a combination of sales, payroll and property, and equipment. The purpose of these apportionment factors is to try and evenly match revenue in each state so that no one state is taking an unfair portion and to ensure a company is not paying taxes on the same income in various states. This is not an exact science, but the theory is to use the apportionment factors to make it equitable. It is generally difficult to change the state in which a company's sales and payroll occurred, so that leaves the third apportionment factor — property and equipment. While it is impractical to move an office prior to year-end, it is possible to move certain pieces of equipment. Moving equipment at year-end to states with more favorable tax rates can allow contractors to lower their state taxes by increasing the apportionment factors in these states and lowering it in states with higher effective tax rates.

More important than the tax savings that may be achieved is avoiding the potential pitfalls and costs of not filing in states where there is an established nexus. For example, if a company decides to file 100 percent of its taxable income in its home state, even though it should have filed in additional states, these additional states can have up to five to seven years to look for past taxes due, which may also include penalties and interest. Since these states may go back past the three-year statute window, a company making this decision will not get the option of amending its original state tax returns, thus paying much more in taxes than if the proper state taxes were filed in all states.

Whether it be a nexus study, research and development study, or an analysis of the best method of accounting, the time to act is now before year-end, when it is too late to analyze and implement the best tax strategy for your organization. There are tax-planning options available to the construction industry, and time and money spent now could lead to thousands of dollars in future tax savings. In this economy, it may provide the much-needed edge over your competition.