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Top 10 Financial and Tax Planning Tips for Contractors

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Top 10 Financial Planning Tips for Contractors

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#1 – Review Insurance and Banking Needs

Insurance

- Review coverage limits and bonding capacity – changes in operations/revenue/payroll
- Ensure new large equipment is covered
- Cyber and fraud insurance coverage
    - Review internal procedures and policies
- Review actual payroll and sales projections against estimated amounts used for workers' compensation and general liability insurances
- Consider new types of insurance: subcontractor, pollution, errors and omissions/professional liability

#1 – Review Insurance and Banking Needs (cont'd)

Banking

- Review banking relationships (are all of your "eggs in one basket?")
- Line-of-credit availability
- Positive pay and other fraud protections
- Explore cash management services offered; Automated Clearing House (ACH) payments and remote deposit
- Interest rate management; consider strategies to manage interest rate risks (Ex: refinancing options, high interest overnight sweeps)

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit

What is the R&D Tax Credit?

- The R&D Tax Credit is a government incentive designed to reward companies for investing in innovation;
- The credit was born in 1981 and became a permanent part of the Federal tax code in 2015 due to its success in stimulating job creation and helping to grow the U.S. as an economic leader; and
- The rules for the R&D tax credit can be found in Internal Revenue Code (IRC) Section 41 and related regulations. The credit applies to any taxpayer that incurs expenses for performing Qualified Research Activities (QRAs).

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit – (cont'd)

What are the Benefits of the R&D Tax Credit?

Some of the potential benefits to realizing the R&D tax credit include:

- Up to 12-16 cents of R&D tax credit for every qualified dollar spent;
- Dollar-for-dollar reduction in your federal and state income tax liability
- Reduction of your effective tax rate
- Improved cash flow; and
- Credit carried forward up to 20 years

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit – (cont'd)

Does your Company Qualify?

To qualify for the credit, you must meet the following four-part test:

1) Elimination of Uncertainty - The activity is performed to eliminate technical uncertainty about the development or improvement of a product or process, which includes computer software, techniques, formulas and inventions; and

2) Process of Experimentation - The activities include some process of experimentation undertaken to eliminate or resolve a technical uncertainty. This process involves an evaluation of alternative solutions or approaches and is performed through modeling, simulation, systematic trial and error or other methods.

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit – (cont'd)

Does your Company Qualify? (cont'd)

To qualify for the credit, you must meet the following four-part test:

3) Technological in Nature - The process of experimentation relies on the hard sciences, such as engineering, physics, chemistry, biology or computer science; and

4) Permitted Purpose - The purpose of the activity is to create a new or improved product or process (computer software included) that results in increased performance, function, reliability or quality.

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit – (cont'd)

What are Some Qualifying Activities for Contractors?

- Developing new or improved products, processes or techniques;
- Developing prototypes or models;
- Developing of environmentally friendly/green methods and processes, or sustainable technology;
- Development of unique assembly or construction methods and processes;
- Experimentation with new building materials;
- Identification of technological improvements in construction processes or to the products and software used;

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit – (cont'd)

What are Some Qualifying Activities for Contractors?

- Development or adaptation of tools, equipment and/or materials to improve efficiency, or the adaptation of construction techniques to consider environmental or land conditions;
- Adapting equipment or processes to meet new regulatory requirements, which includes innovative scaffolding, safe working processes and automation, fire, health and safety, sound and thermal;
- Design and development of new mechanical and electrical systems into buildings, considering Modern Methods of Construction (MMC) and Building Information Modelling (BIM); and
- Any project that required an extra level of testing or certification upon completion

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit – (cont'd)

What are Some Excluded Activities for Contractors?

- Research conducted outside the U.S.;
- Adaptation or duplication of existing business components;
- Market research, testing or development (including advertising or promotions);
- Routine data collection;
- Routine or ordinary testing or inspection for quality control;
- Surveys, studies, activity relating to management function, market research or routine testing/quality control;
- Research related to social sciences, arts or humanities; and
- Research funded by any grant, contract or otherwise by another person (or governmental entity).

#2 – Take Advantage of the Federal Research and Development (R&D) Tax Credit – (cont'd)

What Expenses Can be Claimed (Qualified Research Expenses)?

- Wages paid to employees working on qualified activities such as engineering, design and/or design/build projects (100% of costs incurred);
- Raw materials and supplies used and consumed in the R&D process (100% of costs incurred);
- Contract research expenses paid to a third party for performing QRAs on behalf of the taxpayer, regardless of the success of the research, allowed at 65% of the actual cost incurred; and
- Basic research payments made to qualified non-profit organizations and institutions. Basic research refers to fundamental research that focuses on evaluating theories and hypotheses, regardless of an application. Basic research payments are included at 75% of the actual expense.

#2 – Federal R&D Tax Credit –Amortization of R&D Costs

- Companies are **<u>required</u>** to amortize their R&D costs over five years, starting with the midpoint of the taxable year in which the expense occurs. For R&D activities conducted outside of the U.S., the amortization period is increased to 15 years; and
- This treatment of R&D expenses may significantly reduce the immediate tax benefit for R&D activities in future years.

#2 – Federal R&D Tax Credit –2024 & Future Considerations

- For tax years beginning after 2022, the maximum amount of payroll tax research credit a small business can apply against payroll tax liability increased from $250,000 to $500,000. A qualified small business is any company with no more than 5 years of revenues (start-up company) and less than $5 million in current year revenues with qualifying research activities and expenditures.
- Newly revised drafts of the R&D tax credit form for 2024 require additional qualitative and quantitative information regarding the company itself and each business component generating the credit to be disclosed. Some questions asked may lead to increased scrutiny from the IRS.
- Much of the newly required information should already be contemporaneously documented by businesses.

#2 – Federal R&D Tax Credit – Capitalization Example

- Previously, a corporate taxpayer could expense $100,000 of qualified R&D expenses. The taxpayer would obtain a reduced R&D tax credit of approximately $5,530 (under the alternative simplified method) plus income tax savings of $21,000 ($100,000 x 21% tax rate) for a total tax savings of $26,530; however
- The same $100,000 spent in 2024 and future years may only yield an annual tax savings of $7,630 because of the recent requirement that R&D expenses need to be capitalized instead of expensed. The same $5,530 R&D tax credit, plus $2,100 in tax savings ($100,000 amortized over 60 months starting at the midpoint of the year x 21%).

#2 – Federal R&D Tax Credit – Insight into Future Legislation

- **Will these provisions be ratified or amended by Congress? Will there be a "small business exception?" The answer is, "maybe."**
- Small businesses can opt out of reporting certain information on the newly revised draft of the R&D tax credit form for tax year 2024.
- There is optimism that Congress will create a workaround to eliminate or significantly modify the capitalization rules in 2025, but, as of today, all we have is uncertainty.

#3 – Evaluate your Strategic Plan

Develop business goals (strategic planning)

- Gather market research data to identify trends and economic forecasts
- Evaluate potential risks and uncertainties that could disrupt normal operations

Quantify the financial impact of those goals (budgeting)

- Use market research data to develop revenue forecasts, regularly review and adjust to reflect market changes
- Remember that effective budgeting is part of a continuous planning process, not a once a year exercise.

#3 – Evaluate your Strategic Plan (cont'd)

Obtain commitment to achieve the goals (individual performance planning)

- Define key performance indicators (KPIs) for tracking progress (MORE ON THIS LATER!)

Evaluate the success or failure of plan attainment (plan review)

- Include stakeholders in plan reviews to ensure alignment of business objectives
- Adapt strategies to market changes/business objectives
- Conduct variance analysis to compare actual financial performance against budget

#4 – Take Advantage of the Federal Work Opportunity Tax Credit (WOTC)

What is the Work Opportunity Tax Credit?

- The Work Opportunity Tax Credit (WOTC) is a Federal tax credit available to employers who invest in American job seekers who have consistently faced barriers to employment;
- The Consolidated Appropriations Act (CAA) of 2021 extended the WOTC until December 31, 2025; and
- The WOTC is the most often overlooked credit in the construction arena.

#4 – Take Advantage of the Federal Work Opportunity Tax Credit (WOTC) – (cont'd)

How is the WOTC Computed?

- A credit for employers who hire and pay wages to individuals who are certified by a local agency as being a member of one of 10 targeted groups, in their first year or second year of employment, after performing at least 120 hours of service;
- The credit is equal to 40% of up to $6,000 of qualified wages ($2,400) or 25% of up to $6,000 ($1,500) for individuals who perform fewer than 400 hours but at least 120 hours;
  - For certain qualified veterans, up to $24,000 in wages may be used ($9,600 maximum credit); and
  - Wages for the WOTC can't be used to figure other Federal tax credits (i.e., R&D).

#4 – Take Advantage of the Federal Work Opportunity Tax Credit (WOTC) – (cont'd)

Who Meets the Definition of a Member of a "Targeted Group"?

- Qualified IV-A recipient (Temporary Assistance for Needy Families (TANF);
- Qualified veteran;
- Ex-felon;
- Designated community resident (empowerment zone or renewal county);
- Vocational rehabilitation referral;
- Summer youth employee;
- SNAP recipient (formally the Food Stamps Program);
- SSI recipient;
- Long-term family assistance recipient; and
- Qualified long-term unemployment recipient.

#4 – Federal Work Opportunity Tax Credit (WOTC) – Steps for Employers

What Are the Steps to Claim the WOTC?

1. All new hires should fill out IRS Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit,* page 1, <u>on or before the day the job offer is made</u>;
2. The employer should subsequently fill out page 2 of the form and submit it to the State Workforce Agency (SWA) for the state in which the company is operating. This must be done within 28 days after the eligible worker begins work. See the following link for contacts:

   https://www.dol.gov/agencies/eta/wotc/contact/state-workforce-agencies;
3. Once certified by the SWA, the employee is considered a **<u>qualified</u>** employee;
4. At year-end, determine the wages of the qualified employees and the number of hours worked for the year; and
5. IRS Form 5884, *Work Opportunity Credit,* should be completed and filed out with your tax return. (Note: The deduction for wages must be reduced by the amount of the credit and recorded as a permanent book-tax difference on IRS Schedule M-1 or IRS Schedule M-3).

#4 – Federal Work Opportunity Tax Credit (WOTC) – Example

- For the current year, the company hired the following qualified and certified employees:
  - Susan –

    Qualified Veteran with service-connected disability and unemployed for at least six months in the prior one-year period

    $27,000 & 1,800 hours
  - Jim –

    Qualified veteran unemployed for at least four weeks, but less than six months in the prior one-year period

    $25,000 & 1,600 hours
  - Dave –

    SNAP Recipient

    $3,000 & 200 hours

	Wages	**Hours**	**Eligible Credit Wages**
Susan	27,000	1,800	24,000
Jim	25,000	1,600	6,000
Dave	3,000	200	3,000
	55,000		33,000

	Eligible Credit Wages	**%**	**Credit Amount**
25% Category	3,000	25%	750
40% Category	30,000	40%	12,000
	33,000		**12,750**
			Total Credit

#5 – Perform Contract Review

Perform individual contract review

Benefits of performing contract reviews:

- Can help manage project costs and (hopefully) avoid overruns
- Allows for better proactive estimating for future projects
- Provides transparency to stakeholders (project managers, owners, bonding companies, banks, etc.…)

- Review contract billings and costs compared to budgeted amounts to date
- Investigate discrepancies and maintain adequate documentation for major changes from budgeted amounts
- Evaluate change orders: Have they been submitted? Approved?
- Overhead considerations

#5 – Perform Contract Review (cont'd)

Prepare WIP (Work-In-Process) Schedules

- Budget to actual review can effectively be accomplished through the preparation of Work-in-Process (WIP) schedules
- WIP schedules should show all active and completed jobs during the reporting period

Key components:

- Contract price
- Contract costs (both to date and for the reporting period)
- Estimated costs to complete
- Gross profit (estimated final and actual to date)
- Revenue earned (both to date and for the reporting period)
- Billings to date
- Over/Under billings (Billings minus revenue earned to date)

#5 – Perform Contract Review (cont'd)

- **<u>Example WIP Schedule</u>**

	Total Contract		From Inception to December 31, 2021				At December 31, 2021		Year Ended December 31, 2021			At December 31, 2021		
Contract	Contract Price	Estimated Gross Profit	Revenue Earned	Costs of Revenues Earned	Gross Profit	Billings To Date (Including Conditional Retainage)	Revenue in Excess of Billings and Conditional Retainage	Billings and Conditional Retainage in Excess of Revenues	Revenues Earned	Costs of Revenues	Gross Profit	Backlog	Estimated Costs to Complete	
Job 1	$ 9,524,500	$ 1,423,242	$ 8,256,453	$ 7,022,695	$ 1,233,758	$ 8,412,904	$ --	$ 156,451	$ 8,248,684	$ 7,016,095	$ 1,232,589	$ 1,268,047	$ 1,078,563	87%
Job 2	7,355,500	2,111,972	204,216	145,580	58,636	--	204,216	--	204,216	145,580	58,636	7,151,284	5,097,948	3%
Job 3	3,068,132	797,324	2,689,782	1,990,781	699,001	2,726,981	--	37,199	2,516,931	1,847,218	669,713	378,350	280,027	88%
Job 4	2,954,024	287,751	2,049,455	1,849,818	199,637	2,133,855	--	84,400	2,049,455	1,849,818	199,637	904,569	816,455	69%
Job 5	2,564,000	430,802	883,822	735,323	148,499	258,038	625,784	--	883,822	735,323	148,499	1,680,178	1,397,875	34%
Job 6	2,193,000	380,898	148,039	122,326	25,713	243,505	--	95,466	148,039	122,326	25,713	2,044,961	1,689,776	7%
Job 7	1,263,170	219,826	907,163	749,292	157,871	982,006	--	74,843	677,139	535,515	141,624	356,007	294,052	72%
Job 8	798,759	127,578	113,572	95,432	18,140	125,942	--	12,370	113,572	95,432	18,140	685,187	575,749	14%
Job 9	640,000	160,825	436,927	327,132	109,795	517,198	--	80,271	436,927	327,132	109,795	203,073	152,043	68%
	$ 30,361,085	$ 5,940,218	$ 15,689,429	$ 13,038,379	$ 2,651,050	$ 15,400,429	$ 830,000	$ 541,000	$ 15,278,785	$ 12,674,439	$ 2,604,346	$ 14,671,656	$ 11,382,488	

#5 – Perform Contract Review (cont'd)

Review Contract Estimates

- Accurate estimating is <u>crucial</u>!
- Using historical data from past projects can help make informed estimates
- Inaccurate WIP schedules and estimates can lead to poor billing practices and poor cash management (large amount of underbillings or overbillings)

Project Gain/Fade

- The net change in estimated contract profit % from period to period
- Fade - Bad estimate? Or something out of the contractor's control? (change order?)
- A trend of bad estimates could lead to a concern about the reliability of future estimates

#6 – Take Advantage of the New York State (and other states) Pass-Through Entity Tax Programs (PTET)

- On August 25, 2021, the New York State Department of Taxation and Finance released guidance (Technical Memorandum, TSB-M-21(1)C, (1)I) addressing a recently enacted optional pass-through entity tax (PTET) that partnerships and New York S corporations may elect to pay for tax years beginning on or after January 1, 2021; and
- Entities that elect to be subject to the PTET will pay a graduated tax of up to 10.9% on their NYS taxable income at the entity level, while their individual partners, members and shareholders will receive a refundable tax credit equal to the pro-rata share of taxes paid by the electing entity.

#6 - Take Advantage of the New York State (and other states) Pass-Through Entity Tax Programs (PTET)

Tax Rate Schedule:

If the PTE taxable income is:	then the PTET due is:
$2 million or less	6.85% of PTE taxable income.
greater than $2 million but less than or equal to $5 million	$137,000 plus 9.65% of the excess of PTE taxable income greater than $2 million.
greater than $5 million but less than or equal to $25 million	$426,500 plus 10.30% of the excess of PTE taxable income greater than $5 million.
greater than $25 million	$2,486,500 plus 10.90% of the excess of PTE taxable income greater than $25 million.

#6 - Take Advantage of the New York State (and other states) Pass-Through Entity Tax Programs (PTET)

Why would Taxpayers want to elect to pay a pass-through entity tax?

- The PTET is intended to provide a workaround to the Federal State and Local Tax (SALT) cap that was enacted with the Tax Cuts and Jobs Act (TCJA) of 2017. The TCJA limited deductions for state and local income taxes to $10,000, thus eliminating the deduction for state income taxes for the vast majority of contractors; and
- The PTET will now effectively allow pass-through contractors to take a Federal income tax deduction for their state income taxes, which they were previously disallowed from taking.

#6 - New York State PTET – Who Qualifies?

Eligible partnership: Any partnership (including a limited liability company [LLC], treated as a partnership for Federal income tax purposes) that has a filing requirement under Tax Law §658(c)(1) and is not a publicly traded partnership. A partnership is eligible to make the election, even if it has partners that are not eligible for the PTET credit, including, but not limited to, corporate partners; and

Eligible S corporation: Any New York S corporation (including an LLC treated as an S corporation for New York and federal income tax purposes) as defined by Tax Law §208.1-A that is subject to the fixed dollar minimum tax under Tax Law §209.

#6 - New York State PTET – Who Does Not Qualify?

C Corporations: Not eligible. Not a pass-through entity and are already allowed to deduct state income taxes at the Federal level;

Important Caveat: While Partnerships and New York S Corporations qualify to make the election, they cannot pass-through the PTET credit to certain partners/members/shareholders. These include:

S Corporation partners of a partnership;

C Corporation partners of a partnership; and

Certain non-grantor style trusts.

#6 - New York State PTET – Making the Election

- An eligible entity must elect to opt into the PTET online on an annual basis, and such election is irrevocable for the tax year it is made. The election must be made by an authorized person of the organization, which includes any member, partner, owner or other individual with authority to bind the entity and sign tax returns. CPAs are not considered an authorized person and, therefore, cannot make the election on the client's behalf; and

2024 Election and Future Years: Must be made on or before March 15, 2024.

#6 - New York State PTET – Estimated Tax Payments and Annual Returns

2024 and Future Estimated Tax Payments: Estimated tax payments must be made on a quarterly basis (due March 15, June 15, September 15 and December 15). Each payment should be equal to 25% of the required annual payment for the taxable year, which is the lesser of: (1) 90% of the current year tax; or (2) 100% of the prior year tax;

Annual PTET Returns: Electing entities **must** file an annual PTET return on or before March 15th of the following year. There is a 6-month extension of time, if needed; and

What if my PTET computes to a loss? The electing entity is still required to file a "no balance due" PTET return.

#6 - New York State PTET – Claiming the Credit

Eligible taxpayers must claim their PTET credit on IRS Form IT-653, *Pass-Through Entity Tax Credit*, and attach the form to their individual New York State income tax return. The PTET credit may not be claimed on group returns filed for nonresident partners (i.e., IRS Form IT-203-GR, *Group Return for Nonresident Partners*) or nonresident shareholders of S corporations (i.e., IRS Form IT-203-S, *Non-Resident and Part-Year Resident Income Tax Return*). **Taxpayers with PTET credits exceeding the tax due for the year may get the excess credit refunded.**

#6 - NYS PTET – Example – S-Corporations

ABC Corporation has three owners		
Federal Taxable income is 1.2 million		
Ownership percentages are as follows:		
A	40%	
B	35%	
C	25%	
Total	100%	

Step 1.	Net PTET Income		1,200,000	
Step 2.	Net PTET Income		1,200,000	
	Apportionment %		100%	
	PTET Income		1,200,000	
Step 3.	PTET Income		1,200,000	
	Tax		6.85%	
			82,200	
Step 4.		Ownership	Total Credit	Allocated Credit
	A	40%	82,200	32,880
	B	35%	82,200	28,770
	C	25%	82,200	20,550

•Note: The shareholders receive a combined Federal income tax deduction of $82,200. Assuming they are in the 32% tax bracket, they would recognize Federal income tax savings of approximately $26,000.

#6 - Pass-Through Entity Tax – Other State Considerations

New York State is not the only state implementing a pass-through entity level tax to circumvent the SALT cap. The following three slides show the other states that are implementing similar taxes for 2022 and future years; and

If you are doing business in a multi-state environment, you may want to consider elections in the following states, as well as New York State.

#6 - Other States Currently with PTE Taxes

- Alabama – Elective PTE Tax effective 1/1/2021
- Arizona – Elective PTE Tax effective 1/1/2022
- Arkansas – Elective PTE Tax effective 1/1/2022
- California – Elective PTE Tax effective 1/1/2021
- Colorado – Elective PTE Tax effective 1/1/2022
- Connecticut – Mandatory PTE Tax effective 1/1/2018, Elective starting 2024
- Georgia – Elective PTE Tax effective 1/1/2022
- Hawaii – Elective PTE Tax effective 1/1/2023
- Idaho – Elective PTE Tax effective 1/1/2021
- Illinois – Elective PTE Tax effective 1/1/2021
- Indiana – Elective PTE Tax effective 1/1/2022

#6 - Other States Currently with PTE Taxes

- Iowa – Elective PTE Tax effective 1/1/2022
- Kansas – Elective PTE Tax effective 1/1/2022
- Kentucky – Elective PTE Tax effective 1/1/2022
- Louisiana – Elective PTE Tax effective 1/1/2019
- Maryland – Elective PTE Tax effective 1/1/2020
- Massachusetts – Elective PTE Tax effective 1/1/2021
- Michigan – Elective PTE Tax effective 1/1/2021
- Minnesota – Elective PTE Tax effective 1/1/2021
- Mississippi – Elective PTE Tax effective 1/1/2022
- Missouri – Elective PTE Tax effective 1/1/2022
- Montana – Elective PTE Tax effective 1/1/2023
- Nebraska – Elective PTE Tax effective 1/1/2018

#6 - Other States Currently with PTE Taxes

- New Jersey – Elective PTE Tax effective 1/1/2020
- New Mexico – Elective PTE Tax effective 1/1/2022
- North Carolina – Elective PTE Tax effective 1/1/2022
- Ohio – Elective PTE Tax effective 1/1/2022
- Oklahoma – Elective PTE Tax effective 1/1/2019
- Oregon – Elective PTE Tax effective 1/1/2021
- Rhode Island – Elective PTE Tax effective 1/1/2019
- South Carolina – Elective PTE Tax effective 1/1/2020
- Utah – Elective PTE Tax effective 1/1/2022
- Virginia – Elective PTE Tax effective 1/1/2021
- West Virginia – Elective PTE Tax effective 1/1/2022
- Wisconsin – Elective PTE Tax effective 1/1/2019

#7 – Enhance Financial Statement Analysis

Reporting out of accounting software

- How often is management looking at internal financials?
- How accurate is the accounting data coming out of the system?
- How detailed are your internal balance sheet and income statement?
- How often is management looking at internal financials?
- Is a statement of cash flows being prepared regularly?
- Are revenues/costs being properly allocated to segments/contracts?
- Consider segment reporting by:
  - Division
  - Geographic location
  - Project manager

#7 – Enhance Financial Statement Analysis – cont'd

Period to Period Fluctuation Analysis

- Income statements should present both current month and year-to-date amounts, as well as comparisons to prior years
- How is the overall profit margin trending?
- Are the overhead rates utilized still accurate?

Budget to Actual Comparison

- Assesses the accuracy of financial forecasts and projections
- Shows variances between budgeted and actual performance for the period
- Facilitates effective cost control measures for areas where expenses are higher than expected
- Consider looking at labor, materials, equipment and overhead separately

#8 – Tax Accounting Methods for Contractors

Internal Revenue Code §460

Targeting the construction industry, Internal Revenue Code §460 requires contractors to utilize the percentage of completion method of accounting for long-term contracts, for Federal income tax purposes.

Two exceptions:

- Home Construction Contract
- Small Contractor Exception

#8 – Tax Accounting Methods for Contractors

Home Construction Contract

- By definition, a home construction contract is any contract where 80% or more of the estimated total contract costs are reasonably attributable to the building, construction, reconstruction, or rehabilitation of dwelling units contained in buildings with four or fewer dwelling units.

- Any contractor meeting this criteria is exempt from utilizing the percentage of completion method of accounting for contracts.

#8 – Tax Accounting Methods for Contractors

Small Contractor Exemption

- Defined as a business that meets the gross receipts test for the applicable tax year.

- Gross Receipts Test
  - Met when the average annual taxable gross receipts for the prior three tax periods does not exceed $30,000,000 (2024).
    - Threshold is subject to inflation on an annual basis.

- Any contract meeting this criteria is exempt from utilizing the percentage of completion method of accounting for contracts.

#8 – Tax Accounting Methods for Contractors

Definitions

- Long-Term Contract
  - For Federal income tax purposes, a long-term contract is defined as a contract that spans more than one tax year.
- Small Contractor
  - Defined as a business that meets the gross receipts test for the applicable tax year, also known as the small business exception under Internal Revenue Code §460.
- Large Contractor
  - Defined as a business that does not meet the small business exception under Internal Revenue Code §460.

#8 – Tax Accounting Methods for Contractors

Accounting Methods for Long-Term Contracts

- Percentage of completion
- Completed contract
- Accrual less retainage
- Additional tax deferral items available to contractors

#8 – Tax Accounting Methods for Contractors

Percentage of Completion Method

- Revenue and expenses are recognized based on the percentage of completion ratio determined by dividing total construction costs to date by the total estimated contract costs.
- Required method for long-term contracts for Federal tax purposes, for large contractors under Internal Revenue Code §460.
- Required method of long-term contracts for Alternative Minimum Tax purposes.

#8 – Tax Accounting Methods for Contractors

Percentage of Completion Method Example

Total Contract Revenue: $1,200,000

Total Cost-to-Completion: $800,000

Cost-to-date: $200,000

Percentage of Completion: 25%

Current year revenue under percentage of completion: $300,000

Current year costs under percentage of completion: $200,000

Current year gross profit under percentage of completion: $100,000

#8 – Tax Accounting Methods for Contractors

Completed Contract Method

- Revenue and expenses are recognized when a contract is complete.
- A contract is considered complete once 95% of contract costs have been incurred and the customer has use of the property.
- The completed contract method allows taxpayers to defer revenue recognition until the contract is complete.
- Method available to small contractors.

#8 – Tax Accounting Methods for Contractors

Completed Contract Method Example

Total Contract Revenue: $1,200,000

Total Cost-to-Completion: $800,000

Cost-to-date: $200,000

Percentage of Completion: 25%

Current year gross profit under percentage of completion (see percentage of completion example): $100,000

Current year gross profit under completed contract method: $0

#8 – Tax Accounting Methods for Contractors

Accrual Less Retainage Method

- A retainage is defined as a percentage of billings for services performed that are withheld by the customer until completion.
- A contractor can establish a method of accounting to exclude retainage receivables and payables from accrual basis income until the cash is received and/or paid.
- Large contractors who do not meet the gross receipts test under Internal Revenue Code §460, can utilize this method for short-term contracts.

#8 – Tax Accounting Methods for Contractors

Accrual Less Retainage Method Example

At year-end, the Taxpayer has the following jobs in process:

Contract #101 uncollected retainage $5,000 (Long-Term)
Contract #102 uncollected retainage $3,000 (Short-Term)
Contract #103 uncollected retainage $7,000 (Short-Term)
Contract #104 uncollected retainage $6,000 (Short-Term)

- Total uncollected retainages at year-end $21,000

- Under accrual less retainage method, Taxpayer could exclude $21,000
- Large contractor could exclude retainages on short-term contracts of $16,000

#8 – Tax Accounting Methods for Contractors

Additional Tax Deferral Items Relating to Contractors

- 10% Elective Deferral
  - Contractors may defer recognition of gross profit until a contract has reached 10% completion.

- Non-Long-Term Contract Deferral
  - Contractors may defer the over/under billings relating to short-term contracts.

#8 – Tax Accounting Methods for Contractors

Short-Term Contracts

- Short term contracts are contracts that do not span more than one tax year.
- These contracts are exempt from the required usage of percentage of completion method for large contractors.
- Available methods of accounting include:
  - Cash Basis
  - Accrual Basis
  - Accrual less Retentions

#8 – Tax Accounting Methods for Contractors

Methods of Accounting for Short-Term Contracts

- Cash Basis Method
  - Revenue and expenses are recognized as the cash is collected and/or paid.

- Accrual Basis Method
  - Revenue and expenses are recognized as progress billings are made and job costs are incurred.
    - Taxable income will increase due to overbillings.
    - Taxable income will decrease due to underbillings.

#9 – Evaluate Key Ratios for Contractors

- To help evaluate financial performance, a company can use its financial statements and WIP schedule to evaluate its Key Performance Indicators (KPIs)

- KPI's should be evaluated period to period, but also against industry standards

- Effective KPIs for Contractors are represented by 4 different types of ratios: Profitability, Liquidity, Leverage and Efficiency Ratios

#9 – Evaluate Key Ratios for Contractors (cont'd)

Profitability Ratios

Return on Assets, Return on Equity, Times Interest Earned

Liquidity Ratios

Current Ratio, Quick Ratio, Days Cash, **Working Capital**

Leverage Ratios

Debt to Equity, Asset Turnover, Fixed Asset Ratio

Efficiency Ratios

Backlog to Working Capital, Months in Backlog, Days in AR/AP

#9 – Evaluate Key Ratios for Contractors (cont'd)

General Construction Industry Standards

• Working Capital -	10 – 15% of Annual Revenue
• Debt-to-Equity Ratio -	Below a 3:1 Ratio
• Underbillings -	Less than 25% of Working Capital
• Cash to Overbillings -	Greater than 1:1 Ratio
• Profit Fade -	Less than 10% of the Original Estimate
• **Bonding capacity -**	**10-20 times Working Capital** **10 times Net Worth**

#10 – New Energy Efficient Home Credit for Contractors

- Also referred to as the Internal Revenue Code §45L Credit.
- The previously expired credit has been amended by the Inflation Reduction Act of 2022, as well as IRS Notice 2023-65, to include qualified new energy efficient homes that are acquired in 2023 through 2032.
- To qualify for the credit, eligible contractors must construct or substantially construct a qualified new energy efficient home.
- The home must be acquired by purchase or lease, from the eligible contractor by a person for use as their primary residence during the tax year.

#10 – New Energy Efficient Home Credit for Contractors

Eligible Contractor

- Defined as the person and/or company that constructs the qualified new energy efficient home.
- The contractor must own and have basis in the home during its construction to qualify.

Examples

- Manufactured homes, the eligible contractor is the manufactured home producer.
- If a company purchases a property and has a third-party build the home, the eligible contractor is the company that purchased the property.

#10 – New Energy Efficient Home Credit for Contractors

To qualify as a new energy efficient home, the following must be met for each dwelling unit:

- Must be located in the United States
- Construction must be substantially or entirely completed after August 8, 2005; and
- Must meet certain energy saving requirements as defined in Internal Revenue Code §45L(c).

#10 – New Energy Efficient Home Credit for Contractors

The energy saving requirements outlined in Internal Revenue Code §45L(c) vary based on the classification of each home and the date of acquisition.

- Single-family homes:
  - Must meet the most recent Energy Star Single-Family New Homes Program Requirements applicable to the location of the property, and
    - If acquired before January 1, 2025, apply the Energy Star Single-Family New Homes National Program Requirements 3.1.
    - If acquired after December 31, 2024, apply the Energy Star Single-Family New Homes National Program Requirements 3.2.

#10 – New Energy Efficient Home Credit for Contractors

Single-Family manufactured homes:

- Must meet the Energy Star Manufactured Home National Program requirements in effect on the latter of January 1, 2023, or January 1 of two calendar years prior to the date of acquisition.

Multi-family homes:

- Must meet the most recent Energy Start Multi-family New Construction National Program Requirements, and
- Must meet the most recent Energy Star Multifamily New Construction Regional Program Requirements application to the location of the property.

Any home acquired during 2022 must meet separate requirements.

#10 – New Energy Efficient Home Credit for Contractors

Credit Amounts:

For homes acquired before 2023, the credit ranges from $1,000-$2,000, depending on the requirements met, which include:

- Certifying that the home has an annual level of heating and cooling energy consumption that is at least 50% (or 30% for certain manufactured homes) less than that of a comparable home that meets certain energy standards, with building envelope component improvements accounting for at least 1/5 (or 1/3 for certain manufactured homes) of the reduction
- Meeting certain federal manufactured home rules
- Meeting certain Energy Star requirements

For homes acquired from 2023 through 2032, the credit ranges from $500-$5,000, depending on the certification achieved and requirements met, which include:

- Energy Star program requirements
- Zero energy ready home program requirements
- Prevailing wage requirements

#10 – New Energy Efficient Home Credit for Contractors

How to claim the credit:

- Eligible contractors must use Form 8908 to claim the credit for each qualified energy efficient home sold or leased during the tax year.
- The energy efficient home credit is included as a general business credit, reported on Form 3800.
- For pass-through companies, Form 8908 must be filed at the entity level to claim the credit. If the partners and shareholders are not claiming this credit on property outside the organization, their corresponding share of the credit may be reported directly on Form 3800.

Questions

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