Top 10 List of Provisions for Construction Contractors Included in 2017 Tax Reform

Sarah Windham, Partner | DHG Tax

The last major tax reform legislation was passed in 1986. Since then, the tax rules – Internal Revenue Code amendments, regulations, procedural guidance and court case law – have morphed into a complex system for taxpaying contractors. The recently signed bill is a significant modification to the existing system and the consensus is clear. Most businesses expect their income tax expense to decrease, including contractors.

Though there are many moving parts in the new tax law with the potential to affect businesses and individuals to varying degrees, this article highlights what we consider 10 of the most significant changes for construction companies.

1 Individual Tax Rates and Corporate Tax Rates

The final bill settled on keeping the same number of individual tax brackets as in current existence, seven. However, the new tax law reduces individual income tax rates to 10, 12, 22, 24, 32, 35 and 37 percent, and raises the income levels subject to each tax rate. These rates apply to tax years beginning after December 31, 2017 and beginning before January 1, 2026, unless subsequently extended by future legislation.

On the corporate side, the current graduated tax rate was removed in favor of a flat 21 percent rate for tax years beginning after December 31, 2017.

2 Increase in Small Contractor Exemption Amount

Under prior tax law, contractors whose average annual gross receipts were under $10 million were exempt from using the percentage of completion (PCM) method of accounting for income tax purposes. Under the new bill, the average annual gross receipts requirement has been increased to $25 million. This is effective for any contracts entered into after December 31, 2017. It is important to note that for commercial contracts percentage of completion is still required to be used for purposes of the alternative minimum tax (AMT).

While under the final bill AMT was repealed for businesses taxed as a C corporation, it was not repealed for individuals. However, it did provide for increased individual exemptions. The 2018 exemption amount was increased from $86,200 to $109,400 and the phase out threshold increased from $164,100 to $1,000,000 for married filing joint taxpayers. The exemption amount for single taxpayers increased from $55,400 to $70,300 and the phase out threshold increased from $123,500 to $500,000.

Contractors, other than C corporations, considering making the switch to a method other than PCM for 2018, will want to consider the potential for AMT impacts before making a final decision. If a contractor switches to a method other than PCM for 2018, any contracts entered into before December 31, 2017, would be taxed under the prior method of accounting even if the contract continued into 2018.

3 Pass-Through Income Deduction

Aligning with a reduced corporate tax rate, Congress provided pass-through entities with a deduction for a percentage of their taxable income. Starting in 2018, a deduction will be allowed for taxpayers who have qualified business income (QBI) from a partnership, S corporation, or sole proprietorship, subject to limitations. The 20 percent deduction is limited to the lesser of (1) 20 percent of their pass-through business income or (2) the greater of (a) 50 percent of the W-2 wages paid in the qualified trade or business, or (b) the sum of 25 percent of W-2 wages, plus 2.5 percent of the unadjusted basis of all qualified property. This deduction applies for tax years beginning after December 31, 2017 and beginning before January 1, 2026.

4 Standard Deduction, Charitable Contributions and the Pease Limitation

Personal exemptions are removed in the bill in favor of a higher standard deduction effective for tax years beginning after December 31, 2017 and beginning before January 1, 2026. The new standard deduction amounts will be $24,000 for married filing joint or surviving spouse, $18,000 for an unmarried individual with at least one qualifying child and $12,000 for single filers.

Charitable contributions – which, under old law, were limited to 50 percent of a taxpayer's AGI – will now be limited to 60 percent of AGI effective for tax years beginning after December 31, 2017 and beginning before January 1, 2026. The bill will also repeal the current 80 percent deduction for certain contributions to universities made in connection with athletic seating rights.

The overall limitation on itemized deductions referred to as the Pease limitation will be suspended for tax years beginning after December 31, 2017 and beginning before January 1, 2026. This limitation essentially reduced the value of certain itemized deductions for high income taxpayers by 3 percent for every dollar over the taxable income limit. The phase-out was capped at 80 percent of the total value of itemized deductions.

5 State and Local Tax Deduction

A very impactful change included in the final bill is the limiting of the deduction available to individuals for sales, income, or property taxes paid to state or local tax authority to $10,000 ($5,000 for a married taxpayer filing a separate return) for tax years beginning after December 31, 2017 and beginning before January 1, 2026. This limitation does not apply to property taxes paid or accrued in connection with carrying on a trade or business.

The limitation does not apply to state and local taxes of businesses taxed as a C corporation.

The bill specifically includes a provision that disallows a 2017 deduction for prepaying state or local income tax for a taxable year beginning after December 31, 2017. Any amount paid in a taxable year beginning before January 1, 2018 shall be treated as being paid on the last day of the tax year for which the tax applies.

6 Depreciation Changes

The bill includes a provision that allows for 100 percent expensing through bonus depreciation of certain business assets placed in service after September 27, 2017 through December 31, 2022. The amount of bonus depreciation allowed is then phased-down over four years as follows starting: 80 percent in 2023, 60 percent in 2024, 40 percent in 2025 and 20 percent in 2026. The requirement that the property be new was also removed and replaced with a requirement that the property simply be new to the taxpayer – an impactful distinction.

The bill includes some additional changes that have the potential to benefit many contractors. For example, Section 179 expensing limits will be increased to $1,000,000, with the phase-out threshold being increased to $2,500,000 with both thresholds subject to inflation increases for tax years beginning after December 31, 2017. Furthermore, the definition of qualified property is expanded to include improvements to non-residential real property including roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems if placed in service after the date such real property was first placed in service.

7 Interest Expense Deduction Limitation

The bill also includes a provision that limits the deduction for interest expense incurred by a trade or business to the sum of business interest income, floor plan financing interest and 30 percent of the adjusted taxable income of a taxpayer for the year. For tax years beginning before January 1, 2022, adjusted taxable income will be computed without regard to depreciation, amortization, or depletion expense. Adjusted taxable income is otherwise generally defined as a taxpayer's taxable income without regard to any income, gain, deduction or loss not properly allocable to the trade or business, any business interest expense or business interest income and any net operating loss.

Real property trades or businesses, including rental property activities that qualify as a trade or business, may elect out of the interest deduction limitation if that trade or business uses the alternative depreciation system, which generally results in longer, slower depreciation deductions. Any interest not deductible for any tax year shall be carried forward indefinitely and treated as business interest paid or accrued in the succeeding tax year.

An exemption to these rules applies to taxpayers with average annual gross receipts for the prior three tax years of less than $25 million.

8 Domestic Production Activities Deduction (DPAD) Repealed

For tax years beginning after December 31, 2017, DPAD (also known as Section 199) is repealed. DPAD was a deduction allowed under pre-Act rules that allowed contractors performing new construction or substantial renovation in the U.S. to claim a deduction of up to 9 percent of taxable income (with certain limitations).

9 Like-Kind Exchanges

Under the new law, like-kind exchanges are limited to only exchanges involving real property that is not primarily held for sale. This new limitation applies to exchanges completed after December 31, 2017; however, a transition rule allows like-kind exchange treatment for any property disposed of in an exchange on or before December 31, 2017, or for any property received by a taxpayer in an exchange on or before the same date. This exception generally allows for like-kind exchanges already in process to still take advantage of the current like-kind exchange rules. This may have an impact to contractors who have typically exchanged equipment and machinery in the past.

10 Estate and Gift Taxes and Generation-Skipping Transfer Tax

The law doubles the base estate and gift tax unified credit exclusion to $10 million, effective for decedents dying and gifts made after 2017 and before 2026. The bill also increases the GST exemption to $10 million. This effectively increases the inflation-adjusted exclusion and exemption amounts to $11.2 million ($22.4 million for a married couple) for 2018.

These increased exclusion and exemption amounts will provide planning opportunities for contractors looking to transition their estate in the coming years.

In Conclusion…

As there are far more elements to the tax reform than covered here, contractors may consider familiarizing themselves with the finer details of the changes. Looping in your trusted advisor and CPA is strongly recommended to ensure you are prepared for the oncoming effects – both favorable and complex – to your financial posture.

Sarah Windham
Partner, DHG Tax
sarah.windham@dhgllp.com