5 TAX STRATEGIES CONTRACTORS SHOULD CONSIDER TO REDUCE THEIR INCOME TAX LIABILITY

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Contractors need to invest in tax planning throughout the year to gain the maximum impact. While most tax strategies strive to accelerate income in the current tax year and defer expenses to the next year, strategic tax planning takes into consideration many other factors such as how reducing income for tax purposes will affect a contractor' financial statements, cash position, working capital, and financial ratios. Lenders and sureties rely on the strength of a contractor's financial statements along with the company's character, capacity, and capital when deciding on a lending and bonding program. Customers also review these metrics to ensure that the contractor is financially strong and able to meet their performance obligations. Therefore, it is important to take a holistic approach to tax planning. There are several strategies to consider:

1. **Use the right accounting method.** Contractors should ensure that the tax reporting method for each contract is appropriate by determining which projects are not considered long-term (more than one year). Most contractors use the percentage-of-completion method (PCM) for long-term contracts. However, there are many exceptions that exist that contractors typically do not elect. Residential builders may defer taxable income under other methods. But who is a residential builder under the IRS Code? Homebuilders are obviously residential builders, but so are contractors who build apartments, dormitories, assisted living facilities and prisons. Residential builders generally qualify to use a different tax reporting method for contracts. Other interesting elections should be considered if contractors have paid unit price contracts and retainage receivable. They are among the items that may qualify for a different tax reporting method. Choose the appropriate method for each contract to reduce taxes, it is an overlooked tool.

2. **Qualify for a R&D tax credit.** Contractors may qualify for a research and development (R&D) tax credit if new processes to improve efficiencies or reduce/eliminate uncertainty in the business are developed in the U.S. A R&D tax credit is generally taken on a dollar-for-dollar basis on either the entire qualified project or the portion of the project that meets the criteria of the IRS. If the R&D tax credit is not fully utilized, it may be carried back to the previous year, and carried forward for 20 years. Qualified start-up and small businesses that may not have an income tax liability can offset payroll taxes with the credit.

3. **Assess opportunities for deductions on pass-through entities.** Contractors that are owners or invest in pass-through entities (sole proprietorships, partnerships, most LLCs, and S corporations), can deduct their allocated share of losses to the extent of their basis (debt and equity). Contractors should have a sufficient basis to deduct allocable losses instead of carrying losses to a future year when their income may be lower. In addition, contractors should look for ways to reduce taxable income such as making retirement plan contributions and developing an exit strategy. There are several factors that affect basis and knowing those items could reduce your tax obligation or change the entity structure.

4. **Assess NOL Carryback vs. Carryforward.** Recent legislation now permits net operating losses (NOLs) to be carried back to obtain refunds of prior years taxes. While this may sound appealing, contractors should assess the implications of this tax provision before deciding to take a NOL carryback or carryforward. President Biden has stated that he intends to raise income taxes. Therefore, it is important to determine if it is more advantageous to the take a carryback and refund in a year with a lower tax rate or have the NOL available for future years when income tax rates are expected to be higher. Evaluate current working capital needs along with the company's long term financial stability before making a decision.

5. **Take advantage of COVID Related Tax Credits.** Many tax provisions were implemented under legislation aimed to help businesses and individuals deal with the COVID-19 pandemic and its ongoing economic disruption. These include the Employer Retention Tax Credit, Net Operating Loss Carrybacks, as mentioned prior, and numerous other tax credits for businesses and individuals.

The above tax planning strategies are meant to provide guidance on how a construction company can reduce its income tax liability. There are numerous other tax elections that contractors may be eligible to take. Business owners should consult with an accountant on which strategies are best to implement for their situation. Lastly, change is imminent, so your tax blueprint should be reviewed and reevaluated annually.

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