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INCOME TAX STRATEGIES TO ACCELERATE CASH FLOW

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Planning Ideas

- Qualified Business Income Deduction
- Non Long-term Construction Contracts
  - A/R retainage
    - Change in tax accounting method
- Long-term Construction Contracts
  - Residential (70%/30% Capitalized-Cost Method-PCCM)
  - Under 10% PCM
  - A/P retainage
  - Change in tax accounting method

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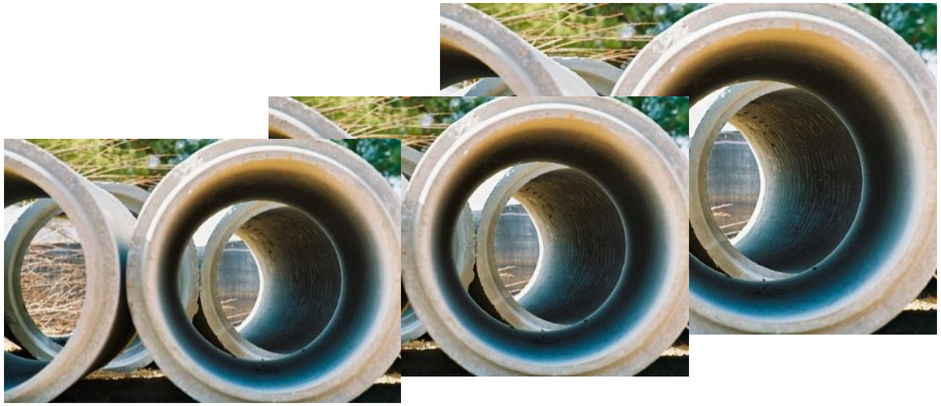
PLANNING IDEAS

- Operate as a C Corporation
- Credit for Increasing Research Activities
- Energy Efficient Commercial Buildings Deduction
- Work Opportunity Tax Credit
- Illinois Sales and Use Tax
- Other State Tax Considerations



Qualified Business Income Deduction IRC 199A

- For pass-through entities, replaces the domestic production activities deduction
  - Does not apply for a C Corporation
- Qualified Business Income (QBI)
  - Includes construction services, engineering and architectural
  - Distinguish from construction management services (perhaps consulting)
- The deduction is the lesser of:
  - 20% of qualified business income (QBI); or
  - 50% of wages related to the QBI

Qualified business income deduction IRC 199A illustration

	Scenario 1		Scenario 2		Difference
Company Income before Owner W-2	5,000,000		5,000,000		-
Owner W-2 Wages	150,000		650,000		500,000
Company Net Income	4,850,000		4,350,000		(500,000)
Tax on Wages @ 37% Top Tax Rate	55,500		240,500		185,000
Tax on QBI @ 29.6% Effective Rate	1,435,600		1,287,600		(148,000)
Total Taxes	1,491,100		1,528,100		37,000
7.4% QBI Effective Savings					

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Non Long-term Construction Contracts - A/R Retainage (cont.)

- Need to review contract. Look for the retention clause that provides the GC or owner can withhold paying the retainage if or until:
  - The taxpayer is in default on its obligations under the contract;
  - Any part of the taxpayer's work is defective;
  - The taxpayer has failed to pay its contractors;
  - Unsatisfactory completion of work;
  - Subcontractor pays all obligations under the subcontract;
  - Resolution of any disputes, liens, claims, etc; and
  - Receipt of executed releases as required under the contract.

Non Long-term Construction Contracts - A/R Retainage

- Contract performance begins and ends in the same taxable year; thus not a long-term contract for income tax purposes
- An accrual basis taxpayer may be able to defer recognition of the account receivable retainage until collected, rather than the year invoiced.
- IRS Revenue Ruling 69-314 allows an accrual basis taxpayer to elect to defer the retainages withhold until they are billable under the contract's terms- which is normally when the contractor has the right to receive the retainage.

Non Long-term Construction Contracts A/R Retainage Change in Tax Accounting Method

- Form 3115, automatic change #130
  - No IRS user fee
  - File with tax return

- Example: 2018 calendar year taxpayer.
  - 12/31/17 A/R Retainage $300,000
  - 12/31/18 A/R Retainage $400,000

  - 2018 IRC 481(a) adjustment $(300,000)
  - 2018 book-tax difference $(100,000)
  - Total 2018 tax deductions $400,000

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Residential (70%/30% Capitalized-Cost Method-PCCM) - IRC 460(e)(5), (6)

- Applies to residential construction contracts
- Definition of Residential
  - Building (apartment, condo) with more than four dwelling units
  - Nursing home, retirement home, prison, college dormitory
  - Does not include a hotel or motel where more than half of its units are used on a transient basis—the same tenant less than 30 days
- 70%/30%
  - 70% percentage completion
  - 30% under an exempt method; for example, completed contract
- Alternative minimum tax preference: 30% exempt method

Residential (70%/30% Capitalized-Cost Method-PCCM) (cont.)

Illustration – Year 1	
PCM gross profit	$1,000,000
Using PCM:	
PCM	700,000
Completed contract	300,000
AMT preference	300,000

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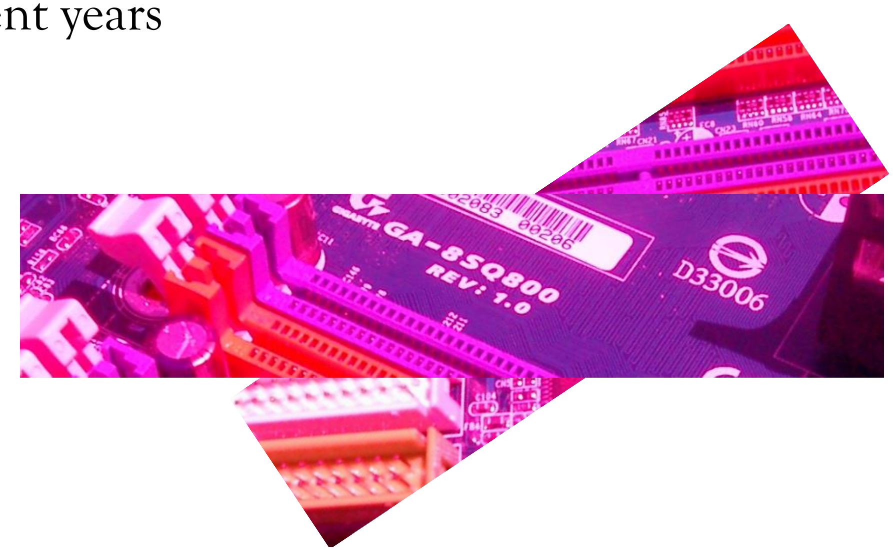
Residential (70%/30% Capitalized-Cost Method-PCCM) (cont.)

Illustration – Year 2	
Job Completed	
PCM	0
Completed contract	300,000
AMT preference	(300,000)

- Change in tax accounting method
  - Need IRS consent; file before end of taxable year
  - IRS user fee

PCM UNDER 10% - IRC 460(B)(5)

- Taxpayer may elect to defer recognition of PCM revenue and related costs until 10% of the total estimated allocable contract costs are incurred. IRC 460(b)(5)
- Election, not an accounting method change
  - Applies to contracts entered into during the election year, and subsequent years



UNDER 10% PCM (CONT.)

Illustration			
	2018	2019	2020
Cumulative Incurred Costs	40,000	300,000	600,000
Total Estimated Costs	600,000	600,000	600,000
Percentage Complete	6.67%	50%	100%
Total Contract Price	11,000,000	11,000,000	11,000,000
Gross Revenues Reported	0	500,000	500,000
Expense Deducted	0	300,000	300,000

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A/P Retainage

- Defer income recognition under PCM if questionable, based on the contract, that the contractor will be obligated to make payment.
- Same rationale as the A/R Retainage
- Not an automatic change in accounting method
  - Need to file Form 3115 before the end of the year in which change to occur
  - Cut-off method; no IRC 481(a) adjustment
  - IRS user fee

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OPERATE AS A C CORPORATION

- 21% flat tax
- No alternative minimum tax
- Potential candidates
  - Minimize owner cash payments (salaries/distributions)
  - Need to accumulate cash
  - Long-term vision to own company
  - Positive that will sell stock rather than assets in a capital event

CREDIT FOR INCREASING RESEARCH ACTIVITIES - IRC 41

- Federal tax credit to promote experimentation
- The "alternative simplified" credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable
- The "general" research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).
- 2015 tax legislation provides that certain taxpayers can use the research credit to reduce alternative minimum tax liability (average annual gross receipts for the three taxable year period preceding such taxable year does not exceed $50 million)

Qualifying Research: Four-Part Test

1. Technological: Research must rely on the hard sciences, including engineering, physics, chemistry, biology, and computer science.
2. Qualified purpose: Research must be intended to create a new or improved product or process, resulting in increased performance, function, reliability, or quality.
3. Elimination of uncertainty: At the beginning of the development process, there must be uncertainty about whether a business component that met your functional requirements **could** be developed, **how** to develop the component, **or** the appropriate design of the business component.
   - In construction projects, uncertainty as to the appropriate design most often occurs in the following project stages: Conceptual design, schematic design, and design development.

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Qualifying Research: Four-Part Test (cont.)

4. Process of experimentation: This involves evaluating more than one alternative to achieve a result where the means of achieving that result are uncertain at the outset; i.e., the alternatives that were considered as a means of eliminating the uncertainties from Test 3.
   - In construction projects, the process of experimentation can include building prototypes, utilizing Building Information Modeling (BIM), and running simulations

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Examples of Qualifying Research Activities in Construction

- Exploring construction techniques, means, and methods
- Preparing structure and facility design for constructability
- Developing and improving construction equipment development
- Designing LEED/green initiatives
- Designing HVAC systems
- Utilizing Building Information Modeling (BIM) for sub-system coordination

Examples of Qualifying Research Activities in Construction

- Analyzing the functions of a design directed at improving performance, reliability, quality, safety and/or life cycle costs
- Performing Request for Information Process (RFI's)
- Improving mechanical equipment sizing

Qualifying Expenses; Forms

- Qualifying Expenses
  - Payroll
  - Supplies consumed
  - Contract expenses (65%)
- Forms
  - IRS Form 6765
  - Illinois Schedule 1299-C

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Documentation of Qualifying Research Activities

- Documentation must cover the process of experimentation showing progression from theoretical calculations and sketches to renderings and prototypes that are physically evaluated
- Ideally, documentation would follow the "scientific method," in which a problem is identified, relevant data are gathered, a hypothesis is formulated from these data, and the hypothesis is empirically tested
- Project records must be retained for at least four years after the last year in which the credit is utilized
- Third party study is advised

Energy Efficient Commercial Buildings Deduction - IRC 179D

- Congress enacted IRC 179D to encourage the energy efficient design and construction of new or rehabilitated properties. This program allows tax exempt government building owners to allocate deductions for energy efficient building envelope, HVAC or hot water systems or interior lighting systems to taxpayers who worked on those systems for the government-owned buildings. Taxpayers eligible to receive an allocation may include an architect, engineer, contractor, environmental consultant or energy services provider.
- Currently available for property placed in service before January 1, 2018

Energy Efficient Commercial Buildings Deduction (cont.)

- Energy efficient commercial building property is depreciable property that satisfies each of the following conditions:
  - Installed on or in any building that is located in the United States
  - The property is installed as part of the:
    - Interior lighting system,
    - Heating, cooling, ventilation or hot water system, or
    - Building envelope.
  - Certified that the systems or envelope incorporated into the building will reduce the total annual energy and power costs by 50% or more as compared to a Reference Building that meets the minimum requirements of Standard 90.1-2001.

Energy Efficient Commercial Buildings Deduction (cont.)

- Deduction shall not exceed the excess of the product of \$1.80 and the square footage of the building, over the aggregate amount of the IRC 179D deductions allowed in the prior taxable years.
  - The deduction rate is reduced to \$.60 for partial energy efficiency expenditures that result in a 16 2/3% reduction in energy costs as compared to a Reference Building that meets the minimum requirements of Standard 90.1-2001.
  - Deduction is limited to the contractor's contract value.
- Illustration: Building has 58,190 sq. ft.; qualify for \$1.80 energy savings. Contractor's contract is \$75,000. Deduction is lesser of \$104,742 or \$75,000.

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Energy Efficient Commercial Buildings Deduction (cont.)

- In the case of energy efficient commercial building property that is installed on or in property owned by a federal, state or local government, or a political subdivision thereof, the owner of the property may allocate the deduction to the person primarily responsible for designing the property. The deduction is allowed for the taxable year that includes the date on which the property is placed in service.
- A designer is a person that creates the technical specifications for installation of the energy efficient commercial building property. A person that merely installs, repairs or maintains the property is not a designer.

Energy Efficient Commercial Buildings Deduction (cont.)

- If more than one designer is responsible for creating the technical specifications for installation of such property , the building owner shall determine which designer is primarily responsible and allocate the full deduction to that designer; or at the owner's discretion allocate the deduction among several designers.
  - General rule of thumb as to who claims the deduction: first to receive the Section 179D allocation letter from the building owner.
- Contractor needs to obtain third party study to support the deduction. Any large deduction will be challenged by the IRS.

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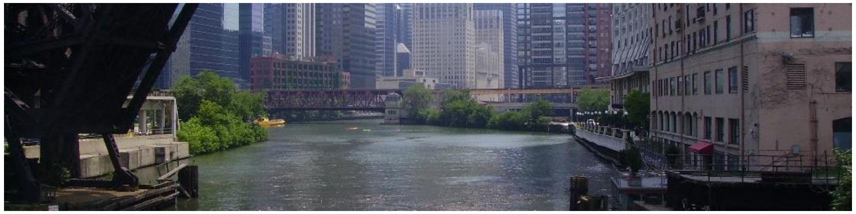
Work Opportunity Tax Credit – IRC 51

- The Work Opportunity Tax Credit (WOTC) is a federal credit available to employers for hiring individuals from certain target groups. The credit applies to eligible employees hired prior to January 1, 2020.



Work Opportunity Tax Credit

- **How the WOTC Works**
- The tax credit employers can claim depends upon the target group of the individual hired, the wages paid to that individual in the first year of employment and the number of hours that individual worked. There is also a maximum tax credit that can be earned.
- For most target groups, the credit is available as follows:
  - If the individual works at least 120 hours, the employer may claim a tax credit equal to 25% of the individual's first year wages, up to the maximum tax credit.
  - If the individual works at least 400 hours, the employer may claim a tax credit equal to 40% of the individual's first year wages, up to the maximum tax credit.

WORK OPPORTUNITY TAX CREDIT (CONT.)

- **WHO QUALIFIES FOR THE WOTC**
  - Veterans – ranges from $2,400 - $9,600
  - Temporary Assistance to Needy Families ("TANF") Recipients – $2,400
  - SNAP (food stamp) Recipients – $2,400
  - Vocational rehabilitation Referrals – $2,400
  - Ex-felons – $2,400
  - Supplemental Security Income recipients – $2,400
  - Designated Community Residents (living in Empowerment Zones or Rural Renewal Counties) – $2,400
  - Summer Youth Employees (living in Empowerment Zones) – $1,200
  - Long-term Unemployment Recipients – $2,400

Work Opportunity Tax Credit (cont.)

- **Maximum Wages**
- Maximum wages are generally $6,000. Exceptions are as follows:
  - TANF Recipients: Year 1 and Year 2 = $10,000
  - Summer Youth Employees: $3,000
  - Veterans:
    - $12,000, if satisfies the compensation-for-disability requirement;
    - $14,000, if satisfies the unemployed-for-six months-in-the-last-year requirement; and
    - $24,000, if satisfies the compensation-for-disability requirement and the unemployed-for-six-months-requirement.

Work Opportunity Tax Credit (cont.)

- **How to Claim the Credit**
- Employer must ask for, and be issued, a certification for each employee for the state employment security agency (SESA). The certification proves that the employee is a member of the targeted group. Employer must either:
  - Receive the certification by the day the individual begins work; or
  - Complete Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, on or before the day you offer the individual a job and receive the certification before you claim the credit.
- If you complete Form 8850, it generally must be signed by you and the individual and submitted, along with Form 9061, to the SESA of the state in which the employee works by the 28th calendar day after the individual begins work.

Work Opportunity Tax Credit (cont.)

- Taxpayer claims federal tax credit on IRS Form 5884.
  - Reduce wage deduction by the credit claimed.

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Illinois Sales and Use Tax - IL Admin Code 130.2115

- Dealing with contractors that install special order fabricated items; such as high rise windows, staircases
- General rule: A contractor is the last party that purchases tangible personal property because upon installing such property into a building, the property is no longer personal tangible property- it is real property. That is the reason why a contractor would not charge the building owner sales tax.
  - The contractor's supplier would charge sales tax on the sales price, unless the building owner is a tax-exempt institution.
  - Contractor would self-assess use tax on the sales price if the supplier is not required to charge the vendor sales tax

ILLINOIS SALES AND USE TAX (CONT.)

- Service occupation tax
  - Customer pays tax on the materials purchased, but not on the services provided. For example, car repair shop.
  - Benefit: pay sales/use tax on a lower base. Could be based on:
    - The supplier's cost of materials
    - 50% of the supplier's total invoice;
  - Applicable when:
    - Contractor hires the vendor primarily for latter's engineering or other scientific skill to design and produce the property on special order for the contractor and to meet its particular needs;
    - The property has use or value only for the specific purpose for which it is produced; and
    - The property has use or value only to the purchaser.
  - Regardless of meeting above requirements, repeat orders will nullify the special status.

Other State Considerations

- Sales and Use Tax
  - Various states have different rules for new construction versus remodels and repairs
  - Some states tax construction-related installation labor
  - MS imposes a "contractor's tax" for nonresidential contracts over a threshold amount
  - Employee income tax withholding when working out of state