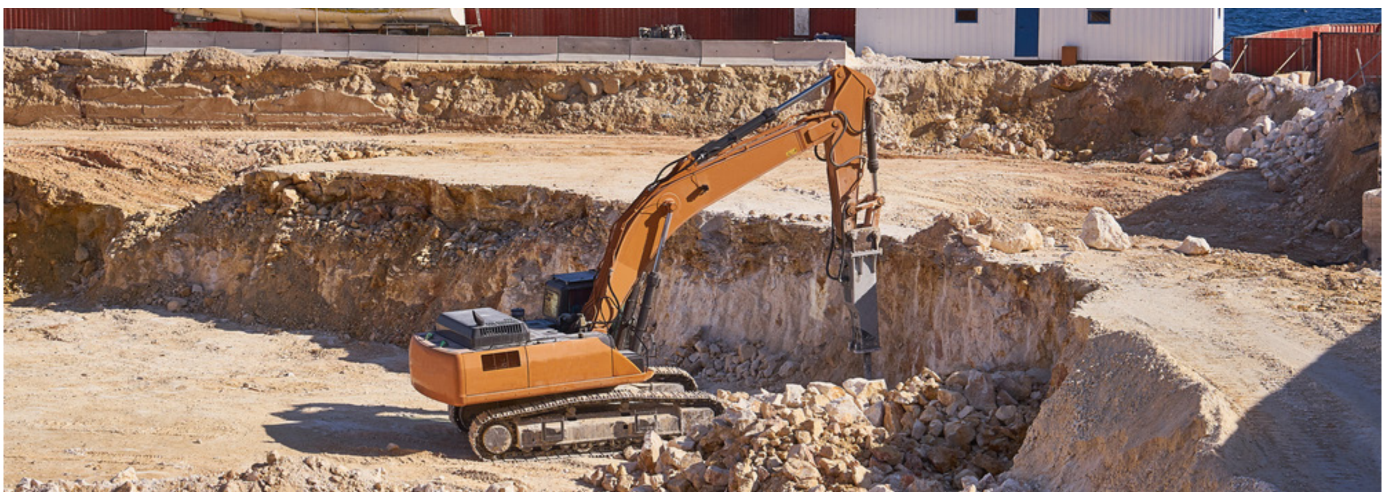
UHY LLP
Certified Public Accountants

CONSTRUCTION INSIDER

VOLUME 12 :: ISSUE 2



TAX IMPLICATIONS FOR CONTRACTORS TO CONSIDER IN THE WAKE OF A DOWNTURN

Due to the current economic uncertainty resulting from the ongoing COVID-19 pandemic, it is more important than ever to understand the tax impacts of a downturn. Appropriate financial preparation for recessionary impacts from a tax perspective can be imperative in surviving such an economic climate.

QUALIFIED BUSINESS INCOME (QBI) DEDUCTION

Effective beginning in 2018 was the 20 percent qualified business income deduction, which has had a positive tax impact for those contractors that have maintained good financial standing. One aspect of this deduction that has been overlooked is that losses from sources generating QBI can reduce the current year deduction to zero. Any unused negative QBI must be carried forward to the following year. Business owners and management need to be cognizant of the effects of a QBI loss and its negative effect on potential deductions, until the deduction is no longer effective post 2025. As of the effective date of this deduction these QBI losses must now be tracked by all related companies.

NET OPERATING LOSSES (NOL)

During economic downturns like the 2008 recession, contractors faced large losses, but were allowed to carry back current year losses, effectively recovering amounts paid for prior period taxes. This is no longer a tax advantage that can be leveraged due to the enactment of the 2017 Tax Cuts and Jobs Act (TCJA). This act repealed prior tax guidance related to NOLs, which allowed NOLs to be carried back two years, with any excess carried forward for 20 years. In addition, this act also allowed taxable income to be offset

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completely. Now due to the issuance of the TCJA for tax years ending December 31, 2017 taxable income can only be offset by 80 percent, and cannot be carried back, but can be carried forward indefinitely. Companies are now also required to track pre-2017 and post-2017 NOLs separately to ensure proper application of these amounts.

BUSINESS LOSS LIMITATIONS

In addition to the provisions related to NOLs changing the ability to use losses in prior and future years, there is also a limitation related to the use of losses in the current year. For tax years beginning after December 31, 2017, losses are subject to loss limitation, which is calculated by taking the excess of a tax payer's total deductions over income attributable to a trade or business plus $500,000 for married taxpayers filing jointly and $250,000 for all other filers. The remaining loss is subject to NOL restrictions as mentioned above and only applies to passthrough entities calculated at the partner or shareholder level, this does not apply to C Corporations. It's key for contractors to understand that losses can now only be applied to those generated by a trade or business (also referred to as non-passive activities). For contractors this would strictly be day-to-day operations. Prior to the implementation of the business loss limitation, businesses were able to offset losses against passive income sources such as capital gains or interest.

INTEREST LIMITATIONS

Another consequence to a contractor incurring losses, especially during a poor economic climate, is the need to obtain loan funding from financial institutions in an effort to generate cash for operations. The related business interest expenses attributed to this debt that can be deducted now have potential limitations for large contractors after the enactment of the Tax Cuts and Jobs Act (TCJA). Per guidelines of the TCJA, large contractors with average annual gross receipts in excess of $25 million will only be allowed to deduct business interest up to 30 percent of their adjusted taxable income. Adjusted taxable income is defined as net earnings before interest, depreciation, and amortization (EBITDA) plus any QBI deductions or NOL taken in the current year. All nondeductible interest expenses incurred above the limitation are carried forward indefinitely.

PERMISSIBLE TAX DEFERRALS

Normally tax deferrals are a means to reduce current year taxes and generate current year liquidity, but they can have reverse effects during a downturn. For instance, one tax deferral option available is the 10 percent method where contractors utilizing the percentage of completion method are allowed to defer the recognition of income from long-term contracts (until at least 10 percent of the estimated total contract costs have been incurred). During times of prosperity a contractor will typically have a significant number of new contracts that are below 10 percent complete allowing the contractor to offset prior year deferred revenue. Unfortunately, in a downturn a contractor will typically not see nearly the same number of new contracts as they would in a booming economy. In effect, prior year deferrals will not be able to be offset by those in the current year, which results in additional income that a contractor may not have anticipated taking on. Additionally, the 10 percent method is not the only type of tax deferral available to contractors and can include, but is not limited to the following:

- The completed contract method for contractors within the "small contractor" threshold and for some home construction contractors;
- The deferral of retainage on short term contractors for those using the accrual method of accounting; and
- The cash method for "small contractors."

CONCLUSION

In light of the ongoing COVID-19 pandemic, all of the aforementioned tax strategies are imperative to consider as the construction industry faces the likelihood of significant losses. Some of the tax advantages that existed during the last recession in 2008, such as carrying back current year losses to generate tax refunds, are no longer possible. In order to best prepare for what lies ahead, it is recommended that businesses actively track their contract losses and speak with their tax advisers to leverage current tax law to the best of their advantage.

> "In light of the ongoing COVID-19 pandemic, all of the aforementioned tax strategies are imperative to consider as the construction industry faces the likelihood of significant losses."

WHAT NEW PPP LOAN GUIDANCE MEANS FOR CONTRACTORS

After the Payment Protection Plan went into effect on April 15, there have been multiple updates, interpretations and news articles regarding the loan program. In a survey by the Associated General Contractors of America, 18 percent of the members that received the loans thought about returning them. New rules are in process to make the program more user friendly.

FEDERAL GUIDANCE UPDATES

The Treasury Department and Small Business Administration (SBA) previously stated that all businesses that applied for PPP loans above $2 million and applied for forgiveness, will be audited. Those who did not provide sufficient evidence to support the forgiveness would be referred to the Department of Justice (DOJ). An update stated: "loans in excess of $2 million would be reviewed by the SBA and may need to be repaid if they did not meet economic requirements set out by the loan, however no penalty of enforcement action or referral to the DOJ would be made." Loans below $2 million were deemed to automatically be "in good faith."

LOANS AND LENDER DUTIES

Under a new rule for PPP Loans, lenders have more duties, including confirming the receipt of the application from the borrower, verifying the receipt of documentation for payroll and non-payroll costs, and checking the numbers for the application. However, the accuracy of the information in the loan is still the responsibility of the borrower.

SPECIFIC CHANGES

Thanks to an amendment to the CARES act called Paycheck Protection Program Flexibility Act of 2020, the following additional changes have since been made:

- Extended the covered period for PPP loans from eight to 24 weeks.
- Funds for forgiveness changed from 75 percent payroll costs/25 percent non-payroll costs to 60 percent payroll costs/40 percent non-payroll costs.
- Created a safe harbor for employers that made a good faith effort to hire or rehire qualified employees.
- Extended the maturity from two to five years.
- Allow the deferral of payroll taxes through the end of 2020.

CONSTRUCTION INDUSTRY INSIGHTS

With regards to the construction industry, the extension of the covered period from the previous eight weeks to 24 weeks for forgiveness is critical, as most contractors are still dealing with backlogged jobs. This should aid construction companies waiting on jobs to resume.

PREPARING FOR LOAN FORGIVENESS

While many contractors found the PPP stimulus money to be helpful, the timing was actually a bit too early. Many contractors could have more effectively used the cash flow six to nine months later than they actually received it. However, it was a needed boost for all industries. As we are now at the end of the 24-week period for most taxpayers, contractors should be putting together their support for forgiveness and working closely with their banks to submit the application to receive forgiveness of the loan from their local bank and ultimately by the SBA.

> "After the Payment Protection Plan went into effect on April 15, there have been multiple updates, interpretations and news articles regarding the loan program."

MOODY'S: EXPECT MORE CORONAVIRUS-INDUCED PROJECT DELAYS

Historically, projects between 2002 to 2019 have experienced delays. Among the worst delays were multi-family projects. An estimated 82 percent were completed at least one month behind schedule, with only 18 percent finishing on time or early. Other sectors including industrial and retail, experienced delays as well, however they were not as drastic. Among the late finishers were industrial projects by four months, office projects by three months, and retail by two months.

Typically, factors behind these late completions are the expected slowdowns such as weather, regulations and building codes, inadequate workforce, and design disputes. The Great Recession that started in late 2007 played into these delays as well.

CORONAVIRUS IMPACT

Unlike previous delays and shutdowns mostly caused by markets, coronavirus resulted in mandatory closures facilitated by the government. The virus also impacted the world's economy by disrupting supply chains and other business processes. Even with mandatory shutdowns lifted, there is still fear of a second wave hitting in late 2020/early 2021, which could result in another shutdown if severe enough.

In early May, a survey conducted by Associated General Contractors of America found that 67 percent of contractors had at least one project canceled or delayed and 30 percent halted work due to shelter-in-place orders.

Despite safety precautions being implemented, it does not guarantee that business will continue at pre-coronavirus levels. Safety and staffing restrictions can make it difficult to make progress.

Overall, it is Moody's general opinion that if interruptions continue, then less progress will be made and delays can be expected on construction projects.

SPECIFIC OUTLOOKS

Nationwide, Moody's predicted that 300,000 multi-family units would be delivered this year. However, post-coronavirus this estimate has been lowered to 246,000 units. If not for coronavirus, multi-family would have delivered a record amount of new construction this year.

Industrial construction needs for warehouse and storage space has seen an increased need due to online shopping. Moody's expects industrial space by the end of 2020 to be 89.3 million square feet, which is down from pre-pandemic 120 million.

Office delays have not been as widely reported, but the use of office space is expected to change drastically with companies going remote. Moody's expects vacancies in office spaces to rise about three points by the end of 2020, which is a record high for the sector.

The retail industry was already seeing slow growth pre-coronavirus as a result of online shopping. Therefore, the delays were not as significant, however delaying only a few of these projects could have a significant impact due to the low volume of work.

Overall, contractors should expect to continue to see lasting effects of coronavirus leading into 2021 and potentially 2022 and plan their projects accordingly to include factors that arose due to the virus.

CONSTRUCTION INDUSTRY INSIGHT

UHY LLP's National Construction Practice is comprised of the country's foremost experts in regards to audit and assurance, tax planning and compliance, and business advisory services for the construction industry. We work with a wide range of key industry segments including general contractors, underground contractors, underwater construction, tunnel, and bridge and heavy highway contractors.

As active members of various national, state and local construction associations, state housing councils and specialty trade groups, our team keeps alert to industry trends and opportunities. Our professionals are leaders in the industry and take the steps necessary to ensure our client's future success by identifying and addressing new accounting requirements and regulations. You can depend on us to anticipate major industry issues that might impact your company and help you structure workable solutions.

OUR LOCATIONS

We have ample locations across the country with a heavy regional presence in the Great Lakes, Mid-Atlantic, Midwest and Northeast. Visit uhy-us.com to find an office near you.