2023 MID-YEAR CONTRACTOR TAX PLANNING CHECKLIST

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The continued impacts of the Inflation Reduction Act of 2022, the Tax Cut and Jobs Act (TCJA) and CARES Act of 2021, continues to drive an active tax policy environment. This constant change requires continued analysis and proactive planning for CPAs and their contractor clients.

The CICPAC Tax Thought Leadership Committee has compiled a brief summary of various tax planning issues potentially impacting our construction clients for consideration. In the interest of timing, this document only provides a brief overview and reminder of areas for further consideration during planning in 2023 and beyond.

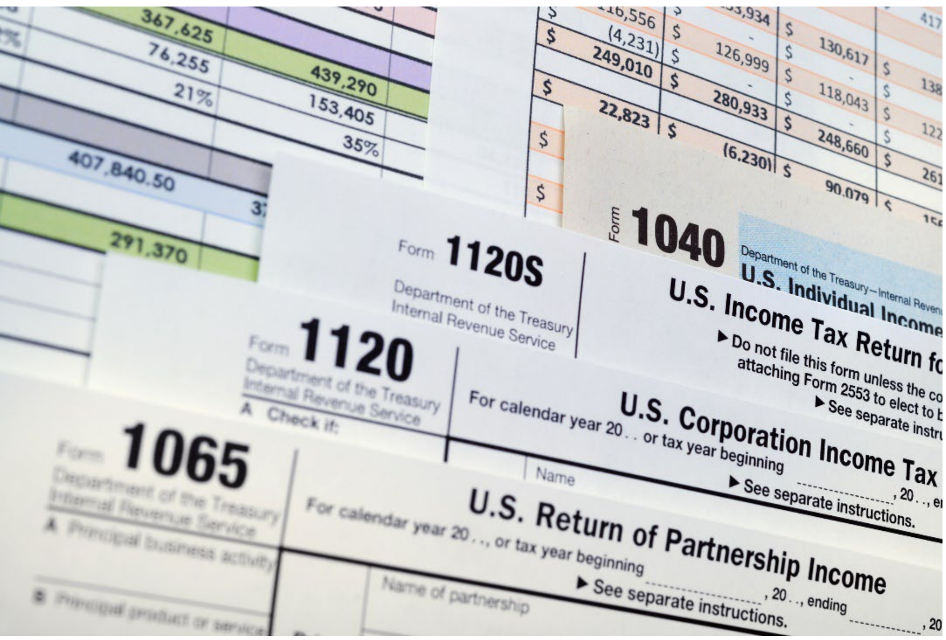
Capitalization of Research Expenses (R&E)

Historically under Internal Revenue Code (IRC) §174, taxpayers had the option to deduct research and experimental costs incurred in a given year. This was the typical default accounting method selected. As part of TCJA, Congress removed the election to deduct these expenditures for all tax years beginning after December 31, 2021. As a result, taxpayers are now required to capitalize all Section 174 expenses and amortize over a five-year period (fifteen years if the research is conducted outside the U.S.) for all tax years beginning after December 31, 2021.

The IRS is yet to propose regulations or issue additional guidance regarding the implementation of this new iteration of IRC §174. However, Rev. Proc. 2023-8 was issued earlier this year to provide an automatic consent procedure for the accounting method change necessary to adopt the new method of accounting. Under 2023-8 the method change is to be applied using a cut-off method. As such, no IRC §481(a) adjustment will be required. Also in lieu of filing a 3115, taxpayers are directed to attach a statement to their tax return for the first tax year beginning after December 31, 2021. The statement must include the following information for each taxpayer:

- The name and tax identification number of the taxpayer that has paid or incurred specified research or experimental expenditures after December 31, 2021;
- The beginning and ending dates of the first taxable year in which the change to the required IRC §174 method takes effect for the taxpayer;
- The designated automatic accounting method change number for the change (265)
- A description of the type of expenditures included as specified research or experimental expenditures;

- The amount of specified research or experimental expenditures paid or incurred by the taxpayer during the year of change; and
- A declaration that the taxpayer is changing the method of accounting for specified research or experimental expenditures to capitalize such expenditures and amortize these expenditures over either a 5-year period for domestic research or a 15-year period for foreign research. The declaration must also state the change is being made on a cut-off basis.



Congress has yet to act to revise or repeal this provision of the law. However, it is believed that there is bipartisan support to do so. Legislation to repeal this provision of the law has been proposed and there is still hope that Congress will adopt this legislation as part of some future act, possibly passed in the 4th quarter of 2023 or early in 2024. Under the current version of the proposed legislation, repeal of this provision will be retroactive for tax years beginning after December 31, 2021. There will likely be an automatic consent approval for an accounting method change allowing impacted taxpayers to recoup the forgone deductions through IRC §481(a) adjustment rather than being required to amend prior year returns.

Business Interest Deduction Limitation

As part of TCJA, IRC §163(j) was expanded to apply to all businesses, with exceptions. Additionally, the maximum deduction allowed for business interest became limited to the sum of:

- The taxpayer’s business interest income for the tax year;
- 30% of the taxpayer’s adjusted taxable income (ATI) for the tax year; and
- Floor plan financing interest expense.

Any disallowed interest can be carried forward to succeeding tax years, subject to the provision of IRC §163(j).

For tax years beginning before January 1, 2022, ATI was computed without regard to any depreciation, amortization, or depletion deduction. These deductions were added back to taxable income to determine ATI. For tax years beginning after December 31, 2021 this add-back rule no longer applies for the calculation of ATI. The expiration of the add-back rule could significantly reduce the interest expense deduction limit for business carrying a significant amount of debt.

As noted, there are exceptions to the application of the provisions of IRC §163(j). An exemption is generally available for small businesses. A small business is defined as businesses whose average gross receipts for the preceding three-year period do not exceed a certain threshold ($27 million and $29 million for tax years beginning in 2022 and 2023, respectively).

In addition to the small business exemption, taxpayers engaged in any real property trade or business as defined under IRC §469(c)(7)(C) may elect out of the application of the IRC §163(j) business interest limitations. As part of making the election, the taxpayer must agree to use ADS depreciation for all nonresidential real property, residential rental property, and qualified improvement property. ADS depreciation must be used for both existing assets and new acquisitions following the election. The change applies both to property placed in service in current and future years and to assets placed in service prior to the date of the election. Rev. Procedure 2019-8 provides guidance on making the election.

Many construction contractors may meet the definition of a real property trade or business. Taxpayers impacted by the changes in the calculation of ATI can still make an election as provided in US Treasury Regs. §1.163(j)-9.

IRS Interest Rates Impact on Underpayment

Over recent years, many taxpayers have become complacent about estimated tax. The interest charged by the IRS for underpayments was historically low, and as such the disincentive for underpayment was small. Due to changes in interest rates, interest charged on underpayments is now much more significant and renewed emphasis should be placed on the necessity of estimated tax planning.

Currently for both corporate and non-corporate underpayments, the interest rate is 7%. More details on IRS interest rates can be found here:

https://www.irs.gov/payments/quarterly-interest-rates#2023

It is also important to note that increased interest rates also impact many estate planning strategies. Some tools may be adversely impacted (intrafamily-loans and installment sales to intentionally defective grantor trusts) while some are enhanced in a higher interest rate environment (qualified personal residence trusts and charitable remainder trusts). Careful consideration of these issues should be included as part of any succession planning or estate planning engagement.

IRS Releases “Dirty Dozen” Tax Scams for 2023

In April, the IRS released its annual “Dirty Dozen” tax scams for 2023, including areas such as abusive syndicated conservation easements, micro-captive deals, and non-filing of returns to name a few. More details on these areas of IRS interest can be found here:

https://www.irs.gov/newsroom/dirty-dozen

Mobile Workforce Reminder

With the increasing mobility of the Contractor’s workforce, a few changes and reminders for consideration for 2023:

- For all of 2023 the IRS increased the standard business mileage rate to 65.5 cents per mile. Up from a rate of 62.5 effective from July 1, 2022 through June 30, 2022.
- Contractors should continue to monitor and follow the U.S. General Services Administration per diem rates which are reset each fiscal year starting October 1st.

- For 2023 Business meal expenses have reverted to where they were prior to 2021, with most business meals now 50% deductible for tax years 2023 and forward. In 2021 and 2022 for some business meals were qualified as 100% deductible.

For a more detailed reminder on current mobile workforce considerations and best practices, access the CICPAC issued whitepaper found at www.cicpac.com.

Depreciation

Contractors have gotten familiar over the last few years of the ability to take 100% bonus depreciation on new and used fixed assets put into place by the Tax Cuts and Jobs Act (TCJA). That 100% level remains for 2022 but starting in 2023 begins to phase out to 80% and continues to step down through 2025. Section 179 may also be a good alternative depending on the dollar amount of additions. For 2023 the section 179 deduction limit is $1,160,000, and limits the total amount of equipment purchased to $2,890,000, with a dollar-for-dollar phase from $2,890,000 to $4,050,000 of total purchases.

Review Retirement Plan Options

The **Setting Every Community Up for Retirement Enhancement (SECURE) Act** was signed into law in December 2019. The Act has favorably changed the deadline for employers to adopt a qualified retirement plan. Employers now have until the business' income tax return deadline, including extension, to adopt a plan and may treat it as adopted at 12/31 of the prior year. There may still be time to adopt a qualified retirement plan for 2022 in addition to exploring plan enhancement options for 2023.

On December 29, 2022, President Biden signed the SECURE 2.0 Act of 2022 building upon the changes from the SECURE Act and further revising rules regarding retirement plans. Some of the key highlights for business owners are as follows:

- Starting January 1, 2023, the age at which owners of retirement accounts must start taking RMDs is increased from 72 to 73. The age at which RMDs must start will be pushed up further to 75 beginning January 1, 2033.
- Starting in 2023, the penalty for failure to take an RMD will decrease to 25% of the missed RMD, down from 50% currently. The IRS still provides for the waiver of these penalties where the account owner establishes that the shortfall in the distribution was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.
- Beginning January 1, 2024, Roth accounts in employer retirement plans will also be exempt from RMD requirements like Roth IRAs.
- Starting January 1, 2025, individuals aged 60 to 63 will be able to make annual catch-up contributions up to the greater of $10,000 (indexed for inflation) or 150% of the standard catch-up contribution for the year to an employer retirement plan. The catch-up amount for individuals 50 and older is currently $7,500 for 2023.
- Beginning January 1, 2024 plan participants earning more than $145,000 in the prior calendar year must make all catch-up contributions to a Roth account in after-tax dollars. Plan providers who currently do not offer a Roth option in their retirement plan should make changes to their plan in order to provide participants with the continued opportunity to make catch-up contributions.
- Historically, all employer contributions to 401(k) plans have been required to be made as pre-tax contributions. Under SECURE 2.0, employers may permit employees to elect that employer matching and non-elective as Roth contributions in after-tax dollars.
- Under SECURE 2.0, any 401(k) or 403(b) plan established after the date of enactment (December 29, 2022) must contain an automatic enrollment provision. Unless the employee affirmatively opts out, they must be enrolled at a contribution rate of at least 3 percent, but not more than 10 percent. Further, after each year in which a participant has completed a year of service, the contribution percentage must automatically increase by 1 percent until the contribution is at least 10 percent but no more than 15 percent.
- Starting January 1, 2024, defined contribution retirement plans can add an emergency savings account that is a designated Roth account. Non-highly compensated employees will be eligible

to contribute up to $2,500 annually to this emergency savings account. Contributions may be eligible for matching contributions. The first 4 withdrawals in a year would be tax-free and penalty-free to the employee.

- Beginning January 1, 2024 employers will be able to make additional matching contributions to retirement plans based on employee student loan payments.

Pass-Through Entity (PTE) Tax Environment

On an individual basis, state and local governments have enacted a pass-through entity (PTE) tax as a potential work around to the Tax Cuts and Jobs Act's (TCJA) $10,000 state and local tax deduction limitation. As of early August 2023, a total of 36 states along with one locality (New York City) have adopted the PTE tax. Reviewing applicability of this process for the multi-state contractor can be key in determining if any benefit exists. States vary on their timing, eligibility, and formality of their PTE tax program.

Eligibility and application of the PTE tax varies from state to state at both the entity and individual level. Care should be taken to evaluate all the applicable rules to determine the impact. For example, some states do not allow resident taxpayers to include PTE taxes paid on their behalf in calculating the credit for taxes paid to other states. For taxpayers in these taxing jurisdictions, the PTE tax paid to a non-resident state could result in a dollar-for-dollar state tax liability in exchange for up to a $.37 federal tax deduction.

Information on states with enacted or proposed pass-through entity level tax statutes can be found here:

https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-pte-map.pdf

Review Contractor Specific Accounting Methods

The Tax Cut and Jobs Act (TCJA) signed into law in late 2017 made some of the most significant tax regulation changes in decades and created many new planning opportunities for contractors. Specifically, various tax accounting methods available to contractors will require ongoing careful analysis and proactive planning, due to the volume of methods and impact this can have on tax liability and cash flow. For a more detailed refresher on tax accounting methods and planning opportunities such as IRC §199A, access the CICPAC issued whitepaper found at www.cicpac.com.

Excess Business Loss/Net Operating Loss/Business Interest

The CARES Act passed in 2020 provided a reprieve from various loss limitations initially implemented in 2018 as part of the TCJA. However, in 2021, these limitations went back into effect such as the excess business loss limitation, inability to carryback a net operating loss, and the excess business interest limitation. These limitations continue to exist in 2022 filings and should be carefully considered and revisited as part of the 2023 planning process. For a more detailed refresher on the specifics of these limitations please access the CICPAC issued CARES Act whitepaper found at www.cicpac.com.

A last-minute change to the Inflation Reduction Act includes an extension of the limitation of an individual's ability to use net operating losses. This limitation, which was included as part of the TCJA, was scheduled to terminate in 2026. The limitation will now apply through 2028.

Excess Business Losses occur when a taxpayer's aggregate trade or business losses exceed trade or business income for the year. Trade or business income includes income or loss from any source including Schedule C and Schedule F in addition to any passthrough trade or business income or loss reported on Schedule E. The ability to deduct losses in excess of income is limited to $270,000 ($540,000 for joint filers) and $289,000 ($578,000 for joint filers) for 2022 and 2023, respectively.

The limitation is taken into account at the owner level and calculated after the outside basis, at-risk and passive loss limitations are applied. Losses suspended under the excess loss limitation rules are carried forward to future years as NOL carryovers.

Employee Retention Credits (ERC)

An important reminder regarding the ongoing ERC process for many Contractors, is if a Taxpayer claims the credit, the corresponding reduction of the deduction (income recognition) related to the salaries which the credit is based takes place in that given 2020 or 2021 tax year. This can typically result in the Taxpayer generating additional income tax while waiting on the refund of any claimed credit.

Be cautious of outside "consultants" pushing the limit for qualifications for ERC. The Internal Revenue Service warns of fraud in employee retention tax credit program. The IRS has slowed the payment of tax refunds to employers under a pandemic era program, as the agency struggles to combat what it says are fraudulent and overstated refund claims being submitted. (WSJ September 5, 2023)

Keep in mind that the IRS has extended the statute of limitations to 10 years. If a taxpayer claims the ERC, their application remains open for audit possibilities for 10 years. If the ERC is disallowed and the regular tax return statute of limitations (3 years) has passed, the taxpayer loses the ability to go back and deduct those salaries. Additionally, AON recently released a risk alert noting that CPAs may be asked to prepare original or amended payroll and/or business tax returns reflecting ERC. As such, CPAs may face a future professional liability claim if a client's ERC is disallowed by the IRS, even if they did not calculate the ERC. Link to the full article is here:

https://www.cpai.com/Education-Resources/my-firm/Tax-Services/Risk-Alert-Aggressive-Employee-Retention

Inflation Reduction Act of 2022 (signed into law August 16, 2022)

In late July of 2022, a deal to revive a scaled back reconciliation bill was reached resurrecting some concepts previously brought forth from the prior year during the Build Back Better proposals. The Inflation Reduction Act of 2022 provides investment in clean energy, promotes reductions in carbon emissions and extends popular Affordable Care Act premium reductions. The bill is being paid for through the implementation of a 15% corporate minimum tax, budget increases to bolster the IRS to close the ‘tax gap’, excise tax on stock buybacks, and changes to Medicare rules. No new business taxes were proposed on pass-through entities or families making less than $400,000.

A few additional proposed details of interest to Contractors are that the corporate minimum tax would go into effect for tax years beginning after 2022 and would equal 15% of the corporation’s ‘adjusted financial statement income’ for the tax year. The tax would only apply to covered corporations with average annual adjusted financial statement income in excess of $1 billion for the three prior tax years. A covered corporation is a corporation whose stock is traded on an established securities market. This would not apply to S-Corporations.

A potential impact on accounting standards and Taxpayer decision making will be an interesting by product of this as a corporation’s ‘adjusted financial statement income’ is the amount of net income or loss a corporation reports on its applicable financial statement.

The bill includes a 1% excise tax on stock buybacks made by publicly traded companies where the total value of stock repurchased exceeds $1 million in a tax year. The excise tax has a few exceptions including nontaxable reorganizations and repurchased stock which is contributed to an ESOP.

Under prior law, qualified small businesses were eligible to elect to apply up to $250,000 of research credit as a credit against payroll tax liabilities. Following the passage of the IRA, this threshold has been increased to $500,000. The first $250,000 of credit is applied as a credit against Social Security tax and the additional $250,000 applied as a credit against Medicare tax. The credit cannot exceed the tax imposed. Any unused credit carries forward.

The Contractor should continue to monitor opportunities arising from the clean energy, climate change and tax credit space of the bill. Specifically impacting the Contractor, the Act expands two key Federal energy efficient tax incentives currently in existence, the **179D Energy-Efficient Commercial Building Deduction** and **45L Energy-Efficient Home and Multifamily Tax Credit,** with expanded credits and applicability starting in 2023. It is vital for the Contractor to review the applicability on these incentives with the work performed. The contractor should review their underlying contracts as the tax benefits may now be allocated to the contractor directly from the State, Municipality and tax-exempt agency. Congress has provided further signals that opportunities in the construction industry from the Inflation Reduction Act will directly evolve around the energy and climate provisions of the legislation, to further promote, expand and incentivize actions around the design, development and construction of energy efficient property.

Thank you

TO OUR COMMITTEE

The intent of this whitepaper is to provide further insight to some of the key issues that you should be aware of as we enter 2023 year-end tax planning with your clients.

Many thanks to the Tax Thought Leadership Committee Members listed below and CICPAC staff for their hard work and efforts in compiling this information for our members and their construction clients.

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