The Tax Cuts and Jobs Act of 2017 (TCJA) introduced sweeping legislation to reform the Internal Revenue Code. Effective Jan. 1, 2018, the act greatly affects how both individuals and businesses plan and structure their entities, taxes and business dealings. Construction businesses in particular need to be aware of potential opportunities and pitfalls that directly result from the act.

While there are some changes that positively affect the construction industry, such as increased bonus depreciation/expensing and historic rehabilitation tax credits, there is also some negative news. For instance, residential contractors may see a slowdown in contracts as a result of the reduced mortgage interest deduction. Companies that rely on loans or lines of credit to finance projects are likely to suffer as a result of a new limitations on the deductibility of business interest.

The following discussion highlights some of these specific changes in the tax law, which will affect construction businesses this year.

**NEW DEDUCTION FOR PASS-THROUGH ENTITIES**

Pass-through entities, including partnerships, limited liability companies and S corporations, are eligible for the new 199A deduction. This tax benefit allows owners of pass-through entities to deduct an amount equal to 20 percent of qualified business income (QBI) derived from the pass-through.

QBI is defined as the net amount of items of income, gain, deduction and loss, with respect to the trade or business. For construction business owners, most of whom operate their trade or business via pass-through entities, there is a significant likelihood of a reduced income tax bill resulting from this 20-percent deduction allowance.

However, one Dallas-based CPA, who represents numerous local contractors, is undecided. “It’s really too soon to see how this is going to shake out for most of my contractor clients,” he said in early October 2018. “Talk to me next year during busy season, and I’ll tell you if the pass-through clients come out better taking the QBI deduction than the C corps with the lower tax rate [of 21 percent].” There are numerous caveats to the 199A deduction, including the requirement that the income must be based in the United States and may not be passive income—such as capital gains, dividends or interest income—and specified service trades or businesses are excluded from the QBI amount.

**BONUS DEPRECIATION INCREASE**

The act increased the Section 179 bonus depreciation from 50 percent to 100 percent, starting in the 2018 tax year. Generally, businesses must depreciate property acquired for business use over the “useful life” of the property. Section 179 allows taxpayers to immediately expense the cost of qualified property that is acquired and placed into service during the reporting tax year.

In other words, businesses that purchase new machinery and equipment are now permitted to immediately expense up to $1 million (increased from $500,000), subject to phase out once the costs exceed $2.5 million (increased from $2 million).

Additionally, the act removed the requirement that businesses be the original user of the property for bonus depreciation, as long as the previous user is not a related person or entity. For construction businesses that purchase qualified real property, such as leasehold improvement property, retail improvement property or restaurant property; new or used equipment; and other qualified property, there is expected to be a direct and immediate benefit from this provision.

One Houston-based contractor specializing in concrete, demolition, earthwork, underground and railroad was pleased to learn about the new opportunity. “After learning about the new 179 depreciation rules, we decided to buy some used excavators that cost us around $900,000. Without being able to immediately depreciate them, we would have been hard-pressed to afford it.” The incremental percentage of expensing available under the act is set to phase down 20
percent every year after 2023 and expire completely for most property placed in service after Jan. 1, 2017.

**LIMITS ON BUSINESS INTEREST DEDUCTIONS**
The TCJA modified the rules regarding the deductibility of interest expense. The new limits on the deductibility of interest expense is equal to the sum of: business interest income, 30 percent of the business's adjusted taxable income and business floor plan financing interest. Business interest that is not allowable as a deduction in the tax year may be carried forward indefinitely.

Additionally, “adjusted taxable income” is determined without taking into account any deductions made for depreciation, amortization or depletion for tax years beginning before Jan. 1, 2022. These limits on the deductibility of business interest could hamper business operations that rely on loans to finance construction projects.

**LONG-TERM CONTRACT SIMPLIFICATION**
The act amended Section 460 to allow taxpayers with average gross receipts of less than $25 million for the prior 3 tax years to be exempt from the requirement of using “percentage-of-completion” accounting method for long-term construction contracts that will be completed within 2 years. This simplified methodology should reduce accounting and bookkeeping expenses for small businesses and contractors.

**HISTORIC REHABILITATION TAX CREDIT**
The act provides for a 20-percent tax credit for qualified rehabilitation expenditures, with respect to a historic structure. “Qualified rehabilitation expenditures” are generally those costs directly related to the repair or improvement of structural and architectural features of a historic building (e.g., hard costs, such as walls, chimneys, stairs, windows and doors and soft costs, such as architect fees, construction management costs and reasonable developer fees). The credit may be claimed ratably over a 5-year period after the structure is placed into service. This doubles the prior one-time, 10-percent credit.

**MORTGAGE INTEREST DEDUCTION LIMITS**
The act reduced the mortgage interest deduction to $750,000 of acquisition indebtedness for debt incurred after Dec. 15, 2017. (Older debt is still subject to the $1-million limit.) It is anticipated that residential construction companies in high-rent areas will see a negative effect from this reduction in mortgage interest deductibility.

David Baxter, principal of Dallas-based residential contractor Accolade Construction, has seen a slowdown. “Last year, before the tax law change, we were having to turn down high-end projects … we could barely keep up,” Baxter said. “We’ve seen that [type of] business start to tail off, and we’re beginning to focus more on midrange price homes. I’m not sure if it’s a long-term deal or if people are just skittish, but we’ll see.”

You should note, however, that the act did not limit the deduction on mortgage interest to the principal residence of the taxpayer only, as was originally proposed. Builders located in popular vacation destinations should feel less impact than they might have otherwise.

After Dec. 31, 2025, the limits will revert $1 million, regardless of the date the debt was incurred.

**THE BOTTOM LINE**
The act is multilayered and is still being absorbed by professionals and the public alike. As such, this is not an exhaustive list of the tax law provisions that will affect those in the construction industry. It is best to work with an experienced tax attorney to identify any actions that need to be taken for your business. CBO