



August 2018

I Will Pay You Tomorrow for a Tax Deduction Today

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Much like the Popeye the Sailor cartoon character, Wimpy, who famously said he would “gladly pay Tuesday for a hamburger today,” taxpayers sometimes choose to defer paying taxes.

The impact of the Tax Cuts and Jobs Act on bonus depreciation

The *Tax Cuts and Jobs Act* (TCJA) passed in December 2017 enhanced bonus depreciation so that now most asset purchases used in the heavy/highway construction segment carry a 100 percent bonus depreciation or immediate expensing. Potentially, this is a great tax result. If a contractor buys a milling machine for \$1 million, he or she receives an immediate federal tax deduction of \$1 million. Keep in mind that under the TCJA, both new and used equipment can qualify for 100 percent bonus depreciation.

A strong economy brings higher than normal volume, margins, and backlog. As such, a robust equipment purchase

program and bonus depreciation can be beneficial and create large book-to-tax differences that reduce taxable income currently. For example, one would receive \$5 million in tax depreciation annually, or a total of \$25 million for a \$5 million annual equipment program over a five-year period.

Conversely, assuming equipment would be depreciated for financial purposes over a five-year period, at the end of five years there would be only \$15 million in depreciation – leaving undepreciated basis for financial purposes of the remaining \$10 million. This means taxable income would be cumulatively \$10 million less over this period. There is no question that this scenario of increased cash flow and lower tax bills is beneficial to the contractor.

Deferring taxes: Considerations and solutions

Let's propose that it is now the taxpayers' version of Wimpy's "Tuesday" – or, the day to which payment was deferred. Backlog is tailing off and the volume cannot support the current equipment center. Putting the maintenance program aside, there is no need for acquisitions. Over the next few years, financial depreciation will exceed tax depreciation by the \$10 million previously accelerated via bonus depreciation. Now, the tax bill is due. Financial income is low due to the reduction in volume and the tail on financial depreciation. Taxable income will greatly exceed financial income due to this \$10 million flip in depreciation over the next few years, potentially creating a large tax bill during a time of low financial earnings.

Often, this flip in depreciation will not be a surprise if a contractor tracks its deferred tax liabilities. C corporations specifically record deferred tax liabilities, reporting to the financial statement users the future tax liability related to book-to-tax differences such as depreciation. But, as is often the case, most contractors are organized as flow-through entities (S corporations or partnerships) and do not report deferred taxes on their financials, thereby losing track of this hidden tax bill.

Contractors should consider annually projecting the tail of financial to tax depreciation for an equipment program. A simple process would be to annually project the next five years of financial and tax depreciation.

This step could help identify early on in which year – or years – depreciation might flip, creating a tax liability. Acquisitions could be planned to help mitigate the flipping of depreciation, or disposals might be needed to cash flow the tax liability. Keep in mind that disposals likely will have zero tax basis, resulting in a larger gain for tax purposes as opposed to book, which cannot be deferred because the TCJA no longer allows gains on equipment sales to qualify for like-kind exchange deferral (IRC Section 1031). Ultimately, planning for this eventuality can help the cash management process.

Other TCJA issues

Heavy/highway contractors should be aware of several other issues under the TCJA related to the 100 percent bonus depreciation, and the first to consider is the new interest limitation. Taxpayers may deduct interest only to the extent that it does not exceed 30 percent of adjusted income.

For tax years beginning prior to 2022, the 30 percent limitation is determined prior to interest, taxes, depreciation, and amortization. It is likely this will not be an issue until 2022. For tax years beginning in 2022 and later, bonus depreciation might create an interest deductibility limitation.

The second issue is the new limitation on net operating losses (NOLs). Historically, taxpayers could carry back NOLs to the prior two years. Under the TCJA, NOLs incurred in 2018 and after may only be carried forward and are deductible only up to 80 percent of taxable income for the applicable period.



Bonus depreciation might create NOLs in the short term for certain taxpayers growing their equipment fleet, but due to the new NOL limitation, the full benefit of bonus depreciation might not be realized for several years – which is contrary to the intended purposes of bonus depreciation.

As a last point of caution, many states have opted out of conforming to federal bonus depreciation provisions. As such, depending on the tax law of each state

of operation, state taxable income might be higher than federal taxable income. Contractors should keep this point in mind as they accrue state income taxes and generate quarterly estimates. State-estimated tax penalties and interest are generally more substantial than those charged by the IRS.

In other words, have your hamburger today – but don't forget the bill that is due tomorrow.

Learn more

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CON-19003-006B