THE $250,000 WEALTHY THRESHOLD: ARE CONTRACTORS RICH WHEN THEY MAKE $250,000?

Paying taxes on income versus cash income. By Bob Mattlin

Being a successful contractor these days is not always easy. Tax laws aren't written to accommodate the construction industry. However, with these tips, contractors will position themselves to succeed.

Politicians in Washington, D.C., don't get it when it comes to contractors and taxes. During the election, "Joe the Plumber" brought the taxing of contractors to the forefront of the national media. It doesn't matter which side of the political fence you are on, Democrat or Republican, the tax proposals from both parties miss the point on taxation. This is especially true for contractors. Cash flow must be taken into consideration before any taxes are computed.

When contractors fill out their tax returns, they are likely to be surprised that they owe a hefty tax bill when there is no cash in their accounts. Not only must the contractor make the final tax payment, but he or she must also make an estimated tax payment based on the current year's results. Politicians categorize the contractor with the W-2 wage person who makes $250,000 and ends up with 75 percent of their income in cash after taxes. More consideration has to be given to the true cash flow of a contractor than ever before.

When contractors' cash flow is taken into consideration, the basis for calculating income taxes on "net income" is silly and just plain wrong. The government has to take the time to study how a contractor generates the cash needed to pay taxes. Cash flow in the construction industry is the worst of all American businesses. Politicians must take the time to understand how a contractor "works."

The following are three distinguishing problems a contractor has that are not shared by most businesses:

- Work-in-progress (WIP) investments (for contractors who have been classified as large contractors by the IRS and are prohibited from using the completed contract method)
- Vagaries of construction billing
- Equipment and tool purchases

It is entirely possible for the contractor to show income of $250,000 and have zero cash to pay the tax. On WIP jobs, the contractor has plenty of expenses to fund the work in progress, but nothing has come in to help reimburse the contractor. At year end, contractors can find they owe $65,000 in taxes on the $250,000 of income because they put all of their cash in the work in progress. They may find that they have to borrow the money to pay taxes, plus the first estimated tax payment for next year.

Examining construction billing procedures is like watching a snail cross the street. Even when contractors can bill for the work in progress that was completed, they often have to wait 60 to 90 days for the invoice to be paid. When it is paid, 10-percent retention (the probable profit in the job) is withheld. Contractors have to pay taxes on that 10 percent just as though they received it. Is it any wonder four out of five contractors go out of business within the first 5 years? Asked why they didn't make it, 90 percent will state that cash-flow problems were the culprit. Even if a contractor is filing taxes under the completed contract method, eliminating the tax

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burden on the work in progress until the job is complete, he or she still faces the same cash-flow problems as the percent-complete contractor.

In addition to the cash flow and WIP issues discussed above, both types of contractors face a serious problem in that they need tools, inventory, and equipment to complete their work. Because of archaic write-off and depreciation laws, these items are not deducted from income except over several years, a little bit at a time. The contractor has to front the cash to buy the tools and equipment. It is easy to see that if a contractor does have a net income of $250,000, he or she could possibly need that much cash to buy a Bobcat, a backhoe, or a variety of other tools.

TAKING ACTION IN THE INDUSTRY

So what can contractors do about it? A good start would be to e-mail this article to a local representative in Washington, D.C., and to any lobbyist that would care enough to read it. Second, contact a tax accountant or lawyer 90 days prior to year end and do some intelligent tax planning. At a minimum, discussion should cover some of the following areas:

- **Take every advantage of Section 179 depreciation that allows the immediate write-off of depreciable assets.** Get the deductions now.
- **Change or start off the accounting procedures using the completed contract method, if possible.** Use a cash basis for accounting (if the contractor meets the IRS guidelines for this method). Cash basis will delay the tax payment on receivables until they are paid.
- **Use projected job costs to calculate revised job estimates.** If a bid item on a job has hit the tank, be sure and take those losses into consideration before filing taxes.
- **Stay on top of billings and negotiate a tight completion definition.** E-mail invoices as soon as they are prepared to the person responsible for paying. Stay in touch, stay in touch, stay in touch.
- **Bill change orders and time and materials work separately from contract billings.** Jump on punch lists to eliminate any excuses for payment.
- **Use purchase orders to manage delivery to prevent material being on jobs before it is needed.**
- **Use a professional document control program.** This helps contractors stay on top of critical submittals, transmittals, requests for information (RFIs), and change orders. Lack of proper documentation is the leading cause for payment being held up for work completed.
- **Maintain tight job schedules.** Communicate with owners or general contractors about when work is expected to be complete and when it will be billed.

There are several other areas where advice from a professional tax consultant can help. Contractors must take advantage of every possible tax angle.

Should taxes be raised on incomes in excess of $250,000, it becomes even more important than ever. There will be no wealth available to spread around if the wealth generators in this country are not in business. ◆