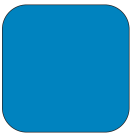


HOW TAX REFORM MAY IMPACT THE CONSTRUCTION INDUSTRY

While the specifics of the promised tax reform are still up in the air, both President Trump and the House Republican blueprint have offered clues that construction professionals can use to begin their tax planning.

AND HOW TO PLAN FOR POTENTIAL CHANGES

DARDEN BELL

As of the date of this article, the public has yet to receive any additional details on potential tax reform other than the general conceptual proposals President Trump released in April 2017 and the House Republican "blueprint" that was released in June 2016. There are numerous differences between President Trump's wishes and what the blueprint set forth in regard to what changes should be made to the tax code, but there is also some common ground between the two proposals. One commonality in particular, the border tax, is what appears to be causing the major delay in the issuance of additional guidance on tax reform.[1] The border tax was first proposed by the House of Representatives blueprint and calls for imposing a tax on imports while lifting a tax on products that are made domestically and exported.[2] The border tax is a critical fulcrum that may determine which direction tax reform will go because the additional revenue that would be generated by this measure is what would offset the lowering of tax rates. However, the border tax has received significant pushback in the business community and a frosty reception from Republican senators who feel

DARDEN BELL, CPA, *is a senior tax manager at Keiter, based in Glen Allen, Virginia. Darden's focus at Keiter includes flow-through taxation, with emphasis on partnership taxation, and the impact on the individual owners of flow-through entities. Many of his clients are concentrated in the real estate and construction industries, including commercial, mixed-use, and residential developments. Darden is a graduate of Virginia Commonwealth University, where he received his Master of Accountancy and Bachelor of Science in accounting.*

that the tax could not pass a vote in the Senate.[3]

The Trump administration and top Republicans in Congress met in early June 2017 to jumpstart discussions on tax reform and begin addressing the roadblocks that are holding up the process. An administration official indicated that we are within a few weeks of agreeing on central aspects of a tax overhaul plan and hope to have actual legislation ready in September.[4] Hopefully that timeline will hold true, but in the meantime we can only focus on the issues we know to be on the table.

What tax issues are on the table?

Even though the House blueprint is much more detailed than President Trump's outline, there is general consensus on the major goals of what tax reform should include. These goals are:

- the need to cut taxes by lowering tax rates for both businesses and individuals;
- the need to simplify the tax code;
- the need to eliminate tax breaks for special interests (this would include the Section 199 deduction, which is commonly used by the real estate industry);
- the need to end taxation of U.S. corporate overseas profits; and
- the need to repatriate an estimated $2.6 trillion in corporate profits held overseas.[5]

Currently, there is not consensus on whether to adopt full expensing of assets for business entities, which would allow companies to write off the cost of capital improvements, such as equipment, immediately.[6] It remains unclear whether the border tax will be a part of the proposed legislation, but given the feedback it has received so far and the discussions taking place about generating that tax revenue using other alternatives, it seems likely that it will not make the cut. If the border tax becomes a part of any legislation that passes, it would have a major impact on companies doing business internationally.

Other items that were included in the House blueprint that President Trump has not publicly commented on include:

- limiting interest deductions to the extent you have interest income, the excess of which would carry forward indefinitely, and
- an indefinite carryforward period for net operating losses (NOLs) instead of the current 20-year carryforward period. In this case, the use of NOLs would be limited to 90 percent of taxable income each year with no carryback available.[7]

While these are the tax areas that have been mentioned publicly by either Congress or President Trump, there will most assuredly be other areas not currently mentioned publicly that will be impacted. We are eagerly awaiting the draft legislation that the government claims will be issued after the August recess so we can gain additional clarity on the overall effects of any changes.[8]

A REDUCTION IN TAX RATES, ESPECIALLY CORPORATE RATES, IS THE FIRST TOPIC THAT SURFACES WHEN DISCUSSING POTENTIAL TAX REFORM UNDER THE CURRENT ADMINISTRATION.

How will these changes impact the construction industry?

Of the areas currently known to be under consideration, those that would have a significant impact on the construction industry include:

- potential reduction in tax rates;
- elimination of special interest items like the Section 199 deduction;
- immediate expensing of capital assets rather than depreciating them (House blueprint);
- limitations on deducting interest expense (House blueprint);
- changes to how NOLs are utilized (House blueprint); and
- one-time deemed repatriation of earnings accumulated overseas under the old system.[9]

Tax rates

A reduction in tax rates, especially corporate rates, is the first topic that surfaces when discussing potential tax reform under the current administration. It is a position that President Trump leaned

on heavily throughout his campaign and seems intent on making happen. The House blueprint also calls for a reduction in rates, but the two sides differ on what those rates should be going forward. The House blueprint calls for a 20 percent rate on entities filing C corporation returns and a 25 percent rate for business income earned by S corporations, partnerships, and sole proprietorships.[10] President Trump's position is that all business income, regardless of the form in which it is earned, should be taxed at 15 percent.[11]

The rates outlined in each side's proposal were contingent upon the border tax being in place to make up for much of the lost revenue from the lower rates.[12] With the border tax appearing to be on life support in the Senate, a retooling of tax rate cuts is likely to occur. It is possible that tax rate cuts will end up being much smaller than originally anticipated due to the lost revenue from the border tax, should that aspect of the plan be removed.

Many construction companies are set up as corporations, whether C corporations or S corporations, rather than partnerships due to the active nature of the construction business. The ordinary income generated by a construction company would typically be considered self-employment income to the business owners who are active in the business if the company filed as a partnership or limited liability company. Hence, it is commonplace to see construction companies set up as C corporations or S corporations to avoid the self-employment tax and to be able to provide additional fringe benefits to the owners that are not always allowable if taxed as a partnership. Those companies taxed as C corporations appear to be in line for the most beneficial drop in tax rates, with both proposals favoring that type of entity. Nevertheless, pass-through entities would still benefit if they were capped at a 25 percent rate, which the blueprint calls for, rather than continuing to be taxed at the higher individual income tax rates as is currently the case.[13] Under both proposals, the upper tier of the individual income tax rates will exceed the business income tax rates. If pass-through entities continue to be taxed at individual rates, a construction company set up as a pass-through entity could end up paying close to double the amount of taxes it would be responsible for if it were a C corporation under the new tax structure. Construction companies currently filing as pass-through entities may want to consider converting to C corporation status should new legislation provide a significant enough benefit to warrant the change.

BOTH PRESIDENT TRUMP'S OUTLINE AND THE HOUSE REPUBLICANS' BLUEPRINT CALL FOR THE ELIMINATION OF TARGETED, OR SPECIAL INTEREST, TAX DEDUCTIONS.

Special interest items: The Section 199 deduction

Both President Trump's outline and the House Republicans' blueprint call for the elimination of targeted, or special interest, tax deductions. Although President Trump's outline does not specifically mention the Section 199 deduction, the House blueprint calls it out as unnecessary.[14] Should tax reform pass, it is possible, if not likely, that the Section 199 deduction will be eliminated.

The Section 199 deduction, otherwise known as the domestic production activities deduction, allows manufacturing and construction companies to claim a deduction equal to a percentage of qualifying income earned from eligible production activities in the United States. That percentage is 9 percent for all tax years beginning after December 31, 2009.[15] This deduction is a perfect example of a special interest item that could be eliminated by any tax reform as a way to offset the drop in tax rates.[16] Eliminating this deduction would impact a variety of industries, including construction and real estate development. If this deduction were eliminated, it would not only offset the benefit of the drop in rates, but it would succeed in simplifying the tax code.

It is unclear at this point in time what other special interest items impacting construction companies could be eliminated under potential tax reform. Although it has not been mentioned thus far, eliminating the materially participating real estate professional classification could have a huge impact on

many taxpayers in the real estate and construction industries. This classification allows owners of real estate and construction companies who satisfy the two eligibility tests (greater than 50 percent of total service time and 750 total hours in the industry) to circumvent the passive activity loss rules of Internal Revenue Code (IRC) Section 469. The materially participating real estate professional classification allows qualifying taxpayers to immediately deduct losses that otherwise may be suspended and carried forward to future years if deemed a passive activity. If the materially participating real estate professional classification is eliminated, it could result in those taxpayers owing more in taxes, as they may no longer be able to utilize their real estate losses to offset other sources of income. Due to the cash flow–centric nature of construction, many companies rely on these tax losses to help get them through tough years. A change to the materially participating real estate professional classification could impact the industry significantly.

Immediate expensing of capital assets and limiting interest expense deductions

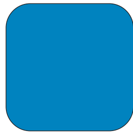
Calculating and tracking depreciation on capital assets can be a very time-consuming and tedious task. The depreciation rules themselves are complex and often require specific software to handle the appropriate calculations. To simplify the tax code, the House blueprint proposes that all capital expenditures, including tangible and intangible assets but excluding land, be immediately deductible.[17] Under this proposal, buildings would be expensed in full during the year of their acquisition rather than depreciating them over 27.5 or 39 years under the current system. All machinery, equipment, and other assets outside of land would be deducted immediately as well.

While that might seem appealing on the surface, the blueprint modifies other aspects of the code to offset those massive deductions. In particular, the blueprint proposes significant changes to the way NOLs can be used. Currently, NOLs can be carried back two years and then carried forward for twenty years if they are not fully utilized on the carryback. The blueprint's proposal would eliminate the carryback option for NOLs, but it would provide for an indefinite carryforward period. Additionally, the use of NOLs in future years will be limited to 90 percent of taxable income each year, similar to how NOLs are currently utilized for alternative minimum tax purposes.[18] While a taxpayer may be able to generate large NOLs in the year of an asset's acquisition, the taxpayer's NOL will not fully offset future income. Since there would no longer be any annual depreciation, amortization, or interest expense deductions, the taxpayer may end up owing taxes in future years unless they were already operating in a taxable loss position for that year.

TO SIMPLIFY THE TAX CODE, THE HOUSE BLUEPRINT PROPOSES THAT ALL CAPITAL EXPENDITURES, INCLUDING TANGIBLE AND INTANGIBLE ASSETS BUT EXCLUDING LAND, BE IMMEDIATELY DEDUCTIBLE.

The other key modification the blueprint proposes to offset this immediate expensing is a limit on interest expense deductions. Interest expense deductions would be limited to the extent of interest income earned for the year; the excess would carry forward indefinitely.[19] Even though the excess would carry forward, it would still only be usable against future interest income. Anyone who has ever financed a purchase, whether a piece of equipment or real property, knows that the total cash outlay for the purchase ends up being substantially more than the actual purchase price due to the interest payments made on the loan. If this change were to pass, a taxpayer would deduct the actual purchase price of the asset in year one, but all subsequent payments of interest could essentially become a nondeductible expense if the amount exceeds interest income. Interest expense is an unavoidable cost of doing business for many companies. To reclassify those cash outlays as nondeductible expenses could be very harmful over the long run to any business who leverages their assets. This may lead to ripple effects throughout the banking and real estate industries, which in turn would have a major impact on construction companies.

Real estate is a cash-driven industry. Most deals are analyzed very carefully from a cash flow perspective before they are even consummated. Having to incur a substantial cash outlay, such as interest expense, without being able to deduct the expenditure could very well cause a deal to fall through. There may not be enough cash available to satisfy debt service, working capital requirements, and tax or tax distribution obligations. Remember, the NOLs can only offset 90 percent of annual taxable income, which will inherently be higher due to the lack of depreciation, amortization, or interest deductions. An entity that often reported annual taxable losses while generating positive cash flow could possibly be looking at annual taxable income with the same amount of positive cash flow. This could cause deals to be squeezed from a cash flow perspective. If this change comes to fruition and causes deals to collapse, construction companies may suffer somewhat due to the lessened demand for their work.



BOTH PRESIDENT TRUMP'S PROPOSAL AND THE HOUSE BLUEPRINT CALL FOR A ONE-TIME DEEMED REPATRIATION OF ALL UNREPATRIATED EARNINGS AND PROFITS.

The last consideration on this front involves the sale of a property. Since purchases will be expensed immediately, the only basis remaining in any property would be the portion of the original purchase price that was allocated to the land. No equipment or building would have any basis remaining. The foregone interest does not add to the basis of the asset, so when the time comes to sell the asset, the only thing a taxpayer would have to utilize against the sales proceeds would be the basis in the land. The taxpayer would end up recognizing a substantial gain on the sale of the property in the year of disposition, and even though they'd have their NOLs to use, they could only be used to offset 90 percent of the income. The taxpayer could end up having to pay a substantial amount in taxes in the year of disposal while still having NOLs carrying forward from the disposed property that have gone unused. That would be another damaging outcome for a very cash-centric industry.

These potential pitfalls are why the immediate expensing of assets in lieu of interest deductions and the use of NOLs could end up costing taxpayers more money in the long run than the current system. While this change could achieve a simplification of the tax code by eliminating the need for depreciation calculations and some of the interest-tracing rules, it could result in unintended consequences that reach much farther than anticipated.

Deemed one-time repatriation of overseas earnings

Companies operating both in the United States and internationally may be impacted by these new proposals. Both President Trump's proposal and the House blueprint call for a one-time deemed repatriation of all unrepatriated earnings and profits. Both claim there are trillions of dollars that have accumulated overseas that have escaped U.S. taxation over the years. President Trump has not yet given any specifics around how he would like to see this handled. The House blueprint proposes a one-time tax at a reduced rate of 8.75 percent on cash and cash equivalents and 3.5 percent in all other cases.[20] The blueprint proposes that this one-time tax be paid in installments over an eight-year period. The purpose behind this proposal is to allow companies to bring those accumulated earnings from overseas back home to be used within the U.S. economy. This deemed repatriation was an accompaniment to the proposed change in how the United States taxes international activity.

Both President Trump and the House blueprint proposed a change from the current worldwide tax system to a destination-based territorial system.[21] This proposed change to a territorial system includes the border adjustment tax on imports, which has not been well received. It is unclear whether the border adjustment tax will survive, although it does not seem likely at this time. If this aspect of the proposal does not pass, would the change to a territorial system crumble? If so, does the one-time repatriation of foreign earnings also fall by the wayside? Each of these issues remains unclear. How the United States will proceed with

taxation of foreign activity is one of the largest and most complex hurdles to clear on any path to real tax reform. It is no secret that corporate inversions have plagued the United States in recent history. The government is looking for a way to stem that tide, but the pushback from the business community and the Senate presents a real obstacle.[22] Any company, construction or otherwise, doing business internationally needs to keep a very close eye on this situation, as it could go either way.

Tax-planning opportunities

Tax planning is an important aspect of running any business, and it becomes more crucial when sweeping changes are on the horizon. Given what we know so far about the potential tax reform, the areas of opportunity for construction companies include maximizing the benefit of lower tax rates, utilizing the most beneficial contract accounting methods available to your business, and mitigating the deemed repatriation of foreign income should that come to fruition.[23]

Maximizing the benefit of lower tax rates

Although we do not yet have clarity on what potential tax reform will entail, there is a clear desire by the parties involved to lower corporate tax rates. Even though there will be some offsets and lost deductions to offset the lowered rates, the overall expectation and purpose of these tax reform proposals is that taxpayers will pay less in total taxes under the new tax regime. Assuming this holds true, companies should be looking for ways to defer income and accelerate deductions in the period immediately before the changes are to take place.

When statutory tax rates remain the same year over year, there is typically no permanent or long-lasting benefit to engaging in an accounting method change for tax purposes. Typical accounting method changes deal with shifting temporary difference items, such as revenue deferral or depreciation of fixed assets, from one year to another, but in the long run, the overall tax impact is the same.[24] The taxpayer is simply trying to determine in which year taking a deduction or recognizing revenue most benefits his or her tax position. However, when there is a permanent change to overall tax rates, an accounting method change could achieve permanent tax savings through the acceleration of deductions or the deceleration of income.[25] An item of expense is much more valuable in a year where the tax rate is 35 percent than a year when the rate is 20 percent. You gain a permanent savings of 15 percent of every dollar of revenue you are able to defer from a 35 percent tax year to a 20 percent tax year.

EVEN THOUGH THERE WILL BE SOME OFFSETS AND LOST DEDUCTIONS TO OFFSET THE LOWERED RATES, THE OVERALL EXPECTATION AND PURPOSE OF THESE TAX REFORM PROPOSALS IS THAT TAXPAYERS WILL PAY LESS IN TOTAL TAXES UNDER THE NEW TAX REGIME.

Typical accounting method changes for construction companies include:

- inventory valuation;
- reduction of Section 263A uniform capitalization;
- last in, first out (LIFO) inventory methods;
- deferred revenue and advance payments;
- prepaid expenses;
- insurance;
- certain service contracts;
- accrued liabilities;
- payment liabilities;
- deferred compensation;
- fixed assets;
- cost segregation of new and/or existing depreciable property;
- software development and intangibles;
- revenue recognition;
- long-term contracts; and
- pension and certain compensation expenses.[26]

Some of the accounting method changes above are automatic consent changes, while some require approval from the IRS. Should any of these methods need to be changed, Form 3115 must be filed in the year of change to accomplish the goal. There are other nonaccounting method change planning opportunities as well — for example, prepaying bonus pools early to fix the liability or chang-

ing contract terms by prepaying expenses.[27] These are changes a taxpayer can make on his or her own without having to notify the IRS of a change, and these changes will accomplish the same permanent tax savings as any of the other changes listed previously.

Utilizing the most beneficial contract accounting method

The IRS has very specific rules regarding construction contracts. These rules can be found in IRC Section 460. Before covering the tax-planning opportunities related to construction contract accounting methods, a general understanding of the rules is necessary. Here is a brief overview.

WITH THE EXPECTATION THAT TAX RATES WILL GO DOWN WITH TAX REFORM, THE ULTIMATE PLANNING OPPORTUNITY AVAILABLE TO ANY CONSTRUCTION COMPANY IS FINDING A WAY TO AVOID THE PERCENTAGE OF COMPLETION METHOD OF ACCOUNTING FOR CONTRACTS.

Long-term contracts. IRC Section 460 defines a long-term contract as any contract that spans more than a single tax year related to the manufacture, building, installation, or construction of property. For example, if a contractor with a calendar-year tax period enters into a contract in October but does not complete the contract until February of the following year, the contract will be considered a long-term contract. If a contract is started and completed during the same tax year, that contract will not be considered a long-term contract.

Percentage of completion. IRC Section 460 mandates that taxable income be reported under the percentage of completion method of accounting. This method requires that revenue be recognized based on the percentage of the contract completed and determined by the total costs incurred to date divided by the total estimated costs to be incurred. The taxpayer includes in gross income the portion of the total contract price that corresponds to the percentage of completion of the project for that year. Using this method can generate undesirable results if income is recognized that taxes must be paid on without the taxpayer having received any, or enough, of the cash yet.

Completed contract method. In certain situations, income may be reported under the completed contract method. Contractors typically prefer this method because income is reported when the project is complete and accepted. By the time the contract is completed, the majority, if not all, of the revenue will have been received; therefore, the taxpayer has the cash necessary to pay the taxes. This method usually results in the greatest deferral of income.[28]

Exemptions. There are a few exemptions to these income inclusion rules for companies meeting certain criteria.

Small contractor's exemption. If the taxpayer's average annual gross receipts for the past three tax years are less than $10 million and the taxpayer estimates the contract will be completed within a two-year period, the taxpayer is exempt from using the percentage of completion method.

Home construction contracts. A home construction contract is any contract where 80 percent or more of the estimated costs are reasonably expected to be attributable to the construction of dwelling units in a building containing four or fewer units and improvements to real property related to those units. Under this exception, a taxpayer is not required to use the percentage of completion method; instead, they can use the completed contract method.

Residential contracts. A residential contract is similar to the home construction contract, except the building is defined as having more than four units. This exception does not apply to transient dwellings, such as motels or hotels. For these residential contracts, a 70/30 hybrid method is allowed. Under this method, 70 percent of the contract is reported according to the percentage of completion method and 30 percent can be reported using the completed contract method.

Election to use the 10 percent method. Even if required to use the percentage of completion method, a taxpayer can elect to defer all income related to a contract if the contract is less than 10 percent complete at the end of the year.[29]

With the expectation that tax rates will go down with tax reform, the ultimate planning opportunity available to any construction company is finding a way to avoid the percentage of completion method of accounting for contracts. Percentage of completion results in the taxpayer recognizing the largest amount of income from a project in the shortest amount of time. The completed contract method, on the other hand, typically results in the greatest deferral of income.[30] Taxpayers who qualify for any of these exemptions but are not taking advantage of them already should consider switching to the more beneficial completed contract method prior to any drop in tax rates. If that can be accomplished, the taxpayer could be permanently saving themselves 10 percent to 20 percent in taxes on the amount of income deferred from the old regime to the new regime. The taxpayer will need to file a Form 3115 to report the change in accounting method, and it is likely that this change in method is considered a nonautomatic consent method change.

In addition to changing the overall method of accounting for contracts as explained earlier, a company that provides other services, such as engineering, architecture, construction management, commercial painting, and computer software development, should take a look at how they are accounting for contracts related to those services. These service-type activities are not considered long-term contract activities unless they are being performed by a related party for the benefit of a long-term contract.[31] Therefore, any contracts related to services rendered are not required to be accounted for using the percentage of completion method. Instead, they can be accounted for using an accrual method.[32]

Another area to consider deals with retainage on a contract. For contracts that are started and completed in the same year, contractors can defer recognizing the retainage receivable as income until the retainage is billable. The billing of retainage typically occurs when the owner accepts the project after completion. If the owner does not accept the job until the beginning of the following year, the retainage can be deferred to the next year. There is also consideration to be given to retainages payable. For long-term contracts, retainages payable are not included in contract costs until the retention is payable to the subcontractor. Accounting for this properly can reduce the overall percentage of the project considered to be complete. Therefore, the amount of income to be recognized is reduced.[33]

The last item to consider relating to contracts is the allocation of direct and indirect costs. Both direct and indirect costs should be allocated to contracts based on a burden rate or some other reasonable method.[34] How this cost allocation is handled impacts the overall completion percentage of a contract. If a reasonable method can be employed that allocates fewer costs to a contract, the taxpayer can keep the overall completion percentage down, which then reduces the amount of income to be recognized from the contract.

IN ADDITION TO CHANGING THE OVERALL METHOD OF ACCOUNTING FOR CONTRACTS, A COMPANY THAT PROVIDES OTHER SERVICES, SUCH AS ENGINEERING, ARCHITECTURE, CONSTRUCTION MANAGEMENT, COMMERCIAL PAINTING, AND COMPUTER SOFTWARE DEVELOPMENT, SHOULD TAKE A LOOK AT HOW THEY ARE ACCOUNTING FOR CONTRACTS RELATED TO THOSE SERVICES.

Options to mitigate potential deemed repatriation

Should the change to our international tax system pass and the one-time deemed repatriation of accumulated foreign earnings and profit come to fruition, there are a few things taxpayers can do to minimize the potential tax liability. If the House blueprint proposals are adopted, then the tax would be determined by the amount of cash, accumulated earnings, and profits left offshore. Because the tax rate applicable to the available cash is higher (8.75 percent) than the rate applicable to the accumulated earnings and profits (3.5 percent), companies with offshore assets should consider how to best reduce their amount of available cash. A few basic ideas are to deploy the cash in the business, to pay down any offshore debt, or to repatriate the cash.[35]

If taxpayers are considering repatriating the cash on their own accord, they should first repatriate from entities that have previously taxed income and then

from any high-taxed earnings that can be fully credited under the current regime. Repatriating voluntarily carries an additional benefit as well. By repatriating the cash, taxpayers are also reducing the amount of earnings and profits held overseas. Bringing back earnings and profits to the United States that can be fully offset by foreign tax credits under the current regime should be considered. It is also possible that Congress could select a retroactive date for the measurement of earnings and profits.[36] Taxpayers may want to consider executing this plan of action now rather than waiting any longer to provide the greatest chance of avoiding the retroactive measurement date.

PRESIDENT TRUMP AND CONGRESS ARE ATTEMPTING TO ACCOMPLISH SOMETHING THAT HAS NOT BEEN DONE IN MORE THAN 30 YEARS: REAL TAX REFORM.

Conclusion

President Trump and Congress are attempting to accomplish something that has not been done in more than 30 years: real tax reform. The process and its outcomes involve numerous divergent interests. Businesses that are highly leveraged and large importers do not wish to see tax reform materialize, in spite of the reduction in tax rates. On the other hand, businesses that are capital intensive and exporters are very hopeful that tax reform will be enacted.[37]

Construction is a unique industry because it includes companies on both side of the aisle. Should tax reform pass and include the foundational elements discussed in this article, there will be some winners, and there will be some losers. In order to be one of the winners, taxpayers should keep a very close eye on the situation and begin planning immediately for whatever changes make it through the legislative process. If tax rates truly end up dropping, there is a real opportunity for permanent tax savings through deferral of income and acceleration of deductions.

A member of the Tax Legislative Counsel for the Office of Tax Policy at the U.S. Department of the Treasury recently told me that if tax reform is going to actually happen, it needs to happen this year. With so many members of Congress up for reelection next year, the likelihood of any tax reform passing diminishes immensely should it lag beyond 2017. At the same time, he stated that he has never seen so many highly motivated members of government focusing on getting something passed. We will all just have to wait and see what happens in September. Hopefully, they will give us something to build on. ■

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