BY RICH SHAVELL

How Contractors Can Navigate the Alternative Minimum Tax (AMT)

The alternative minimum tax (AMT) is calculated alongside regular income tax and is intended to prevent taxpayers from paying too little income tax after utilizing various tax minimization strategies.

Since AMT is eliminated for C corporations for tax years beginning in 2018, this article will focus on pass-through entities such as S corporations and partnerships.

The AMT & Long-Term Contracts

For regular income tax calculations and depending on the levels of gross receipts, contractors may use the completed-contract method (CCM) or other recognition methods like the cash method to account for long-term contracts.[1] While either the CCM or cash method is permitted for long-term home construction contracts (HCCs) for AMT purposes, neither method is approved for calculating alternative minimum taxable income (AMTI) for other long-term commercial construction contracts.

Small contractors that use accounting methods other than the percentage-of-completion method (PCM) are generally required to recalculate their long-term contracts using PCM to determine AMTI.[2] Thus, contractors can use more favorable tax reporting methods for regular tax purposes but must generally use the PCM for AMT purposes. While this diminishes the tax benefits of the CCM, it does not eliminate the benefit – which is why many contractors are willing to face the AMT's complex machinations.

How the AMT Can Affect Contractors

To illustrate the impact of the AMT, let's examine the differences between CCM used for regular tax purposes and PCM required under AMT. Consider the hypothetical company ABC Construction, a contractor with a single long-term contract for $2 million and projected costs of $1.6 million (along with a $400,000 estimated gross profit).

As of December 31, 2018, ABC incurs and pays construction costs of $720,000 and also bills and collects $800,000. Under the CCM, ABC does not have any taxable income related to its long-term contract for regular tax purposes because it only recognizes the revenue it receives and the costs paid once the contract is completed. Under the PCM, ABC Construction recognizes 45% of the contract's revenue because the contract is 45% complete ($720,000 costs incurred are divided by $1.6 million total estimated costs) as demonstrated in Exhibit 1.

Therefore, in Year 1 of the contract, ABC faces a positive AMT adjustment of $180,000. This is the variance between regular taxable income of zero under the CCM vs. $180,000 ATMI under the PCM at year-end.

If the cash method is used, then the AMT adjustment would be $100,000. Cash collected was $800,000 less costs of $720,000, or $80,000 net. This is compared to the AMTI of $180,000.

Next, assume that as of December 31, 2019, ABC completed its long-term contract. ABC incurred and paid the remaining construction costs of $880,000 and billed the remaining $1.2 million. With no changes to estimates, ABC's AMTI for Year 2 is equal to the remaining 55% of the contract. Its regular taxable income is equal to the total contract gross profit of $400,000 under the CCM.

Since there was a positive $180,000 AMT adjustment in the prior year ($180,000 gross profit was already recognized for AMT purposes), in continuing to use the CCM, ABC reports a negative AMT adjustment of $180,000 for Year 2, as shown in Exhibit 2 on the following page.

EXHIBIT 1
Year 1: December 31, 2018

	Regular Taxable Income Under the CCM	Alternative Minimum Taxable Income (AMTI) Under the PCM
Revenue	$0	$900,000
Expenses	$0	$720,000
Taxable Income	$0	$180,000

EXHIBIT 2 Year 2: December 31, 2019		
	Regular Taxable Income Under the CCM	Alternative Minimum Taxable Income (AMTI) Under the PCM
Revenue	$2,000,000	$1,100,000
Expenses	$1,600,000	$880,000
Taxable Income	$400,000	$220,000

For AMTI purposes, the total impact over the life of the contract nets to zero. For Year 2, a regular taxable income of $400,000 is compared to AMTI under the PCM of $220,000, which equals the negative $180,000.

The tax effect typically corresponds to the AMTI impact – in other words, the alternative tax is computed on the elevated AMTI and temporarily increases total tax. When the AMT is greater than regular income tax, the difference is generally carried forward to offset future tax years' regular tax when the regular tax exceeds AMT.[3]

This AMT credit generally cannot be carried back and cannot reduce regular tax below the current year's tentative minimum tax.[4] The AMT credit carryover only reduces regular tax to the point where the computed tentative minimum tax would equal regular tax. The balance of the unused AMT credit continues to carry forward.[5]

AMT Computations

Both corporations and individuals are subject to AMT for tax years beginning before December 31, 2017, but the 2017 *Tax Cuts and Jobs Act* (TCJA) repealed the AMT for C corporations for tax years beginning January 1, 2018 or later.[6] While not taxpaying entities themselves, S corporations and partnerships must provide their shareholders and partners with the computed pass-through AMT adjustments, which the individual shareholders/members use to calculate their tax liability.

To illustrate the resulting tax liability from AMT adjustments, assume that in 2018, ABC Construction has $425,000 in regular taxable income but $675,000 in AMTI. Let's suppose a married taxpayer is filing a joint return where the regular taxable income would be subject to the marginal regular income tax rate of 35%, but the AMTI of $675,000 would be subject to an AMT tax rate of 28%. Actually, the income subjected to the AMT rate of 28% is permitted an exemption amount. Moreover, other positive and/or negative adjustments may impact AMTI and therefore the AMT computation.

For 2018, a married filing joint return is permitted an exemption of $109,400[7] (which has increased from $78,750 in 2017). There are also phase-out rules for this exemption beginning after $1 million for 2018.[8]

It is important to note that there are two AMT rates depending on statutory AMTI thresholds: 26% and 28%.[9]

The Tax Cuts & Jobs Act

TCJA increased the prior three-year average annual gross receipts threshold from $10 million to $25 million[10] for classifying small or large contractors. As a result, more contractors are eligible to account for long-term contracts under alternative methods other than PCM and thus, may become subject to AMT. However, the 2017 tax law did increase the AMT exemption amounts for individuals such that less income is subject to AMT.

As of 2018, a portion of the AMT credit carryover becomes refundable for C corporations (which are also no longer subject to the AMT).[11] For tax years 2018 through 2020, 50% of the unused AMT credit (after the current year's credit is applied) is refundable, and in 2021, this percentage increases to 100%.[12]

For example, assume that a C corporation with zero tax liability from 2018 through 2020 has $100,000 of AMT credit carryover into 2018. The C corporation can claim a $50,000 refundable credit in 2018, $25,000 (50% of the remaining balance) in 2019, $12,500 (again, 50% of the remaining balance) in 2020, and the remaining $12,500 in 2021.

Summary

Despite the additional tax imposed by AMT, it is generally advantageous for taxpayers to claim the tax deferrals available that require additional AMT computations. Not only is income tax deferred to future years, which results in immediate cash flow, but future marginal income tax rates (e.g., from 2017 to 2018) may also be lower. Significantly, more contractors operating as pass-through entities may face AMT and other beneficial, regular tax reporting methods now that the small contractor revenue threshold has increased to $25 million. ■

Endnotes

1. IRC §460(e)(1)(B).
2. IRC §56(a)(3).
3. IRC §53(b).
4. IRC §53(c).
5. IRC §53(c)(2).
6. IRC §55(e), as amended by 2017 *Tax Cuts and Jobs Act* §12001(b)(6).
7. IRC §55(d)(4)(A)(i)(I).
8. IRC §55(d)(4)(A)(ii)(I).
9. IRC §55(b)(1)(A).
10. IRC §448(c)(1) and IRC §460(e)(1)(B)(ii).
11. IRC §53(e).
12. IRC §53(e)(2).

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