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CONSTRUCTION INDUSTRY ADVISOR

THE HOFFMAN GROUP
Certified Public Accountants & Consultants

hoffmancpas.com | 443.320.4101 | 1.410.630.5001 fax

10055 Red Run Boulevard | Suite 130 | Owings Mills, MD 21117

A fresh look at the pass-through deduction

Is your construction business organized as a sole proprietorship or pass-through entity (such as a partnership, S corporation or limited liability company)? If so, the new 20% "pass-through" deduction can be a valuable tax break.

But the deduction is subject to complex limits and restrictions. That's why it's important to review your situation carefully to determine whether you're eligible and to identify potential strategies for maximizing its benefits. Proposed regulations published in August 2018 — which you can rely on until final regulations are issued — provide guidance.

A quick refresher

The pass-through deduction — found in Section 199A of the Internal Revenue Code — allows eligible owners to deduct 20% of their qualified business income (QBI) from eligible businesses or 20% of their taxable income (excluding net capital gains), whichever is less. QBI generally means your allocable share of the business's net income from a trade or business conducted within the United States (including Puerto Rico). It doesn't include investment income, reasonable compensation from an S corporation or guaranteed payments from a partnership.

The deduction may be reduced or eliminated if your taxable income exceeds a certain threshold: $315,000 for married couples filing jointly, $157,500 for everyone else. Above the threshold, two important limits apply:

1. Exclusion for certain service businesses. For a "specified service trade or business" (SSTB), the deduction is gradually phased out. It's eliminated when taxable income reaches $415,000 for joint filers ($207,500 for others). Construction isn't a listed SSTB, but a "catchall" provision disqualifies a business whose "principal asset … is the reputation or skill of one or more of its employees or owners."

2. Wage and capital limit. The deduction is limited to the greater of 1) 50% of the company's W-2 wages or 2) 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property (generally, depreciable business property). This limit is phased in over the same income ranges as the SSTB exclusion.

The proposed regs

Some contractors feared that Sec. 199A's catchall language would encompass companies in any industry — including construction — whose success was tied to name recognition or word of mouth. Fortunately, the proposed regulations interpret this provision very narrowly, limiting it to owners or employees who generate income from endorsements, licensing of their image or likeness, or appearance fees.

Another concern was that many contractors provide consulting services — which is on the list of SSTBs — relating to their construction projects. The proposed regs clarify, however, that the exclusion doesn't apply to consulting services that are:

> … embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

Even if these services are paid for separately, however, you'll avoid SSTB treatment so long as they account for less than 10% of your gross receipts (5% if your gross receipts exceed $25 million).

The proposed regs also include several provisions that will help contractors minimize the impact of the wage and capital limit. Under one provision, owners may elect to aggregate separate related businesses for Sec. 199A purposes, so long as they are commonly owned, are part of a larger integrated business and meet certain other requirements. The election can be advantageous if, for example, one company has high QBI and low wages and capital, while a related company has low QBI and high wages or capital.

Another provision allows entities that lease real estate or other property to commonly controlled businesses to claim the pass-through deduction, even if these rental activities don't rise to the level of a "trade or business." This may be helpful for construction businesses that set up separate entities to lease real property or equipment to one or more operating entities.

Planning ideas

If you have QBI from a pass-through entity or sole proprietorship and your taxable income is below the threshold, you're generally entitled to the full deduction. If your taxable income exceeds the threshold, here are some tips for maximizing the deduction:

Bundle your charges. If your business provides consulting services to construction clients, be sure they aren't purchased or billed separately, to avoid being treated as an SSTB.

Consider hiring. If your deduction would be reduced or eliminated because the business has insufficient wages, depreciable property or both, consider strategies for increasing them, such as aggregating related businesses or hiring employees in place of independent contractors (keeping in mind that adding employees will increase your employment tax and benefits costs).

Increase benefits contributions. If feasible, look to reduce your taxable income below the threshold by boosting contributions to qualified retirement plans. A cash balance plan, for example, may enable your business to make generous contributions on behalf of owners without having to make significant contributions for rank-and-file employees.

The most of it

Contact your CPA to discuss these and other strategies for making the most of this tax break. He or she can also apprise you on the final regulations when they're issued. ■

Watch out for antiabuse rules

Even if you're otherwise eligible for the pass-through deduction, beware of new "antiabuse" rules. For example, under proposed regulations, an employee who converts to independent contractor status to qualify for the deduction, but who continues to perform substantially the same services, is presumed to be an employee for Section 199A purposes.

The proposed regs also contain provisions designed to prevent companies from "stripping out" business segments that qualify as a "specified service trade or business" (see main article) into separate entities to become eligible for the deduction.

Following the fundamentals of employee retention

The skilled labor shortage has been a problem for so long that you might be tired of reading about it. Yet, on a nationwide basis, the fact remains that construction businesses face a great challenge in hiring and retaining well-trained and experienced workers.

If your construction company has good people on board right now, you've got to keep them. Given the cash flow fluctuations inherent in the construction industry and every business's inherent budgetary restrictions, simply "paying 'em more money" probably isn't the answer. What does generally help is following certain fundamentals when it comes to employee retention.

Safety and work environment

You might think employees' chief interest is making as much money as possible. But workers understand that compensation tends to fall within a certain range and it's unlikely that they're going to find an employer who drastically exceeds that range. Many employees look much more at work environment. Simply put, will they be safe and happy working for your company?

Consider teaching employees how their skill sets can contribute to keeping projects within budget.

Obviously, when it comes to construction, safety is paramount. A business that takes care of its employees and doesn't cut corners on safety to save money or speed up projects will more likely retain

its skilled workers. So, be sure to track your safety performance closely, and regularly check to ensure that everyone is following rules and protocols.

Beyond physical safety, company culture also plays a role in work environment. Most construction workers place a high value on hard work and sticking with a job until it's done right. Sometimes this leads to competition between workers and teams. This can produce greater employee job satisfaction — and productivity — if it doesn't cross the line into unhealthy rivalries or hostile conflicts.

Training and development

Most workers want to do a good job. So, determine which skills are the most critical to your employees' success and then create a training program designed to "upskill" your workers. This means not only teaching them how to do their jobs currently, but also building on those skills for the future.

Don't stop there. In addition, provide ongoing training directly related to their jobs. Consider offering seminars, workshops and informal "lunch 'n' learns" to help your employees widen their knowledge base. This might include teaching them how their skill sets can contribute to keeping projects within budget.

Performance management

It's human nature for employees to want to know how they're doing, and your employees are no different. Many construction companies conduct annual performance reviews for in-office staff but may do so less frequently for field workers. Consider a companywide performance management program that includes regular reviews and goal-setting for everyone.

Giving employees feedback only once a year, however, probably isn't enough. Encourage supervisors to meet with workers more regularly. These discussions shouldn't involve only criticisms. On the contrary, they should be opportunities to provide praise, ask about well-being, and solicit ideas about how to complete work more safely and with greater quality.

Competitive compensation

While money isn't everything, it does matter. Re-examine your compensation plan periodically to see whether it has kept pace with the marketplace and your competition. Also make sure that project goals and incentives are realistic, given factors such as the conditions on a jobsite and the availability of materials and equipment.

If you're not sure what your competitors are paying, your CPA can help you conduct a benchmarking study using trade publications or other available data. You may need to adjust your compensation to keep up.

A multifaceted approach

There's no single, simple way to retain good employees. Every construction company needs to take a multifaceted approach that makes sense for their size, market and specialty. The good news is that, once you find the "formula," you'll likely see positive results and an improvement in your business's reputation. This can make hiring a little easier, too. ■

Steel yourself against rising materials prices

Tariffs on steel and aluminum have recently contributed to an increase in materials costs. There are many other factors that can cause prices to escalate, too, including shortages brought about by building booms in other parts of the country or world; environmental issues, such as loss of forestlands; and rising fuel and other transportation costs.

What can contractors and subcontractors do to mitigate this risk? Here are some ideas to consider.

Revisit your bidding

One option is to build some cushion into your bids to reflect the risk of materials price hikes. This approach is dangerous, however: If you overestimate the risk you may lose out on jobs, and if you underestimate the risk you may jeopardize your profitability.

Another option is to consider bidding on smaller, short-term jobs. These are less vulnerable to fluctuating materials prices.

Talk to your suppliers

It's important to develop and maintain strong relationships with your suppliers. Doing so will help you stay informed about tariffs and other developments that may affect prices in the future and about programs available for locking in raw materials prices for a specified period. These relationships may also give you access to materials you need during times when supplies are short.

One specific topic to broach with your supplier is whether you might purchase bulk materials in advance. This can help control costs if you have the storage space and your materials needs are reasonably predictable. Naturally, you'll need to weigh the impact on your cash flow and storage costs.

Build protection into your contracts

Among the most effective strategies is to shift some of the risk to the owner (or general contractor) by negotiating a provision in your contracts that adjusts the price periodically to reflect fluctuations in materials costs. An advantage of this approach is that it enables you to protect yourself against materials price fluctuations while keeping your bids as low as possible. Because there's no need to build a cushion into your bids to absorb the risk of volatile materials prices, the owner benefits from lower initial prices.

Often, these provisions are referred to as "escalation clauses" because they target rising materials prices. But such clauses are more palatable to owners if they also provide for downward adjustments in the event materials prices fall.

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Design escalation clauses carefully

It's important to design escalation clauses carefully, paying attention to the events that trigger a price adjustment. It's common to provide for an adjustment in the event materials prices rise or fall by 2% or 3%, as substantiated by:

- The contractor's actual invoices from suppliers,
- One or more published price indexes, or
- Some combination of the two.

The clause should also specify when price adjustments are to be made, such as at the end of the contract or at fixed intervals (such as quarterly) during the life of the contract. Work with your attorney to ensure that an escalation clause achieves your objectives and that there are no other contractual provisions that override it.

Track prices carefully

Tariffs have added another layer of complexity to the challenge of managing materials costs. But careful tracking of the rise and fall of prices and savvy timing of purchases can help matters.

Mixed reality: The next BIM thing in construction tech?

Building information modeling (BIM) is one of the most important technological developments in construction history. As you're no doubt aware if you've used it, the software helps everyone involved resolve design conflicts and other issues before construction begins. When used to its maximum potential, BIM can also enhance quality, speed and productivity while reducing costs.

Most important, BIM doesn't sit still. It keeps evolving and offering more dynamic functionality that, not so long ago, may have seemed like science fiction. The latest BIM buzzword is "mixed reality," which isn't yet widely used in practice but promises significant benefits not just to the design and planning of projects but to the construction process itself.

Basics of BIM

As you may know, BIM software creates models that facilitate collaboration by enabling parties to view the completed project from different angles and to better understand the spatial relationships between building components. It also incorporates specific materials and other building information into the early stages of the design process and allows the parties to see how various changes affect the project.

Today, BIM can even be integrated with virtual reality technology to create immersive, three-dimensional digital experiences that allow you to virtually walk through a model or construction site without leaving the comfort of your home or office. This technology facilitates collaboration and reduces travel costs.

Augmented reality

Mixed reality, as the name suggests, combines virtual reality with the real-world construction site. It allows architects, owners, construction workers and others to walk through a partially completed project and view models overlaying the physical environment, typically using hardhat-mounted headsets.

Mixed reality is a form of "augmented reality," which superimposes computer-generated images on one's view of the real world. But mixed reality goes a step further, anchoring those images to real-world objects, ensuring that models are correctly and permanently positioned as the user moves about the project.

The potential benefits of mixed-reality BIM are profound. For example, it allows you to compare plans to work completed to date and to detect design errors before they're implemented. And by enabling workers to see models overlaid on the jobsite, it makes the construction process more efficient, avoiding the errors and delays that can result when workers rely on confusing or difficult-to-follow paper plans.

A revolutionary concept

Although mixed reality isn't quite ready for prime time, it promises to revolutionize the construction industry. So, keep an eye on this technology as it's further developed and refined. ■

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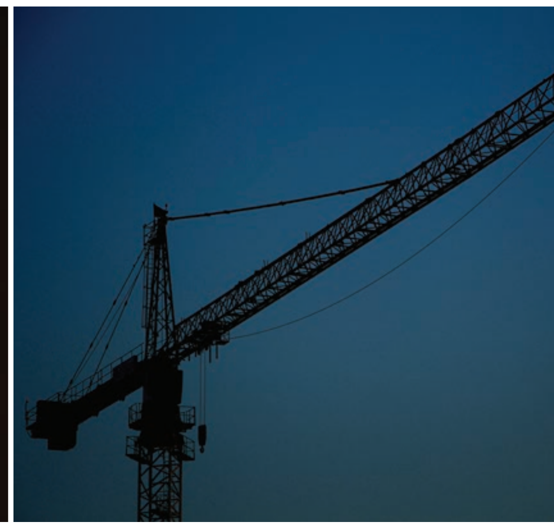

We Know Construction

Rapidly changing technology, market conditions, cost overruns, safety liability and high insurance costs are just a few of the challenges the construction industry faces. Whether your business tends to the residential, governmental, or commercial sectors, our qualified staff has extensive experience with tax compliance, project management, bonding, job costing, employee benefits, business succession planning and information technology. We help to reduce tax costs while remaining in compliance with federal, state, and local regulations, giving you time to focus on your business.

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