



# CONSTRUCTION INDUSTRY ADVISOR

Tax planning

**Dig deep to determine the TCJA's total impact**

3 tips for dealing with design issues

Exploring the many facets of an ESOP

We're covered, right?  
Additional insured provision doesn't guarantee protection



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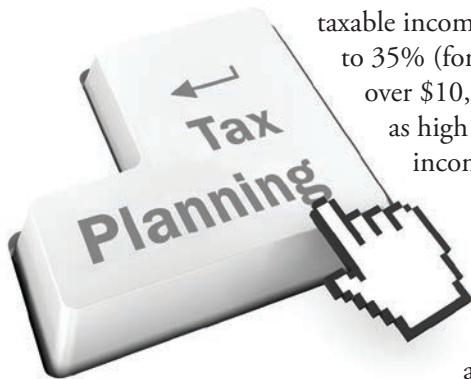
## Tax planning

# Dig deep to determine the TCJA's total impact

**T**he passage of a new tax law in December was intriguing news for most construction company owners. Now that the dust has settled, let's take a look at some of the highlights of the Tax Cuts and Jobs Act (TCJA).

### Tax rates reduced

Most construction companies will see their tax rates go down in 2018. The TCJA reduces the C corporation income tax to a flat 21% rate. Previously, corporations were subject to graduated tax rates ranging from 15% (for taxable income up to \$50,000) to 35% (for taxable income over \$10,000,000), with rates as high as 39% at certain income levels in between.



Construction companies organized as pass-through entities — such as S corporations,

partnerships, limited liability companies and sole proprietorships — are still taxed at their owners' individual rates. But the TCJA benefits these owners in two ways. First, it lowers individual income tax rates, with the top rate dropping from 39.6% to 37% (through 2025). Second, the law allows pass-through owners to deduct 20% of their qualified business income, which translates into an effective top marginal rate of 29.6% on business income.

A reduced deduction is available to owners whose taxable income exceeds a specified threshold (\$157,500 for individuals; \$315,000 for joint filers). For these owners, the deduction is limited

to the greater of 50% of the company's W-2 wages, or 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property (generally, depreciable tangible property used in the business).

This provision doesn't change the requirement to pay reasonable compensation to owners; rather, it's designed to prevent owners from abusing the new deduction by recharacterizing wage income as business profits.

### Depreciation breaks increased

The TCJA allows 100% bonus depreciation (up from 50% in 2017 and 40% in 2018) for equipment, certain building improvements and other qualifying assets placed into service after September 27, 2017, and before 2023. After that, the tax break will phase out by the end of 2026. For the first time, bonus depreciation is available for both new and used assets.

In addition, the act permanently increases the Section 179 expensing limit, allowing you to deduct, rather than depreciate, up to an inflation-indexed \$1 million (previously, \$500,000) in new and used equipment and other qualifying assets. The new threshold applies to property placed in service in tax years beginning after December 31, 2017. Eligible assets now include certain depreciable personal property used to furnish lodging, as well as roofs, HVAC systems, fire protection and alarm systems, and security systems added as improvements to nonresidential buildings.

The deduction is phased out once a company's total purchases for a year exceed an inflation-indexed \$2.5 million (up from \$2 million).

## And now some bad news ...

Not all of the news regarding the new tax law is good for construction companies. Some valuable tax breaks have been eliminated or scaled back. For example:

**State and local tax deductions.** The new tax law limits the itemized deduction for state and local income taxes and real estate / property taxes to \$10,000 per year. This provision could impact contractors who have larger state and local taxes paid at the individual level because of “pass through” income and/or W-2 income.

**Section 199 deduction.** This tax break has been eliminated. It allowed many construction companies a deduction for certain qualified domestic production activities.

**Net operating loss (NOL) usage.** NOLs can be used for only 80% of taxable income for tax years beginning after 2017, and NOL carrybacks are eliminated. The new law does, however, allow you to carry NOLs forward until they’re used. The elimination of the NOL carryback could significantly affect the construction industry because the loss carrybacks available under previous law provided tax refunds that eased cash flow concerns during economic downturns.

**Interest expense deductions.** Tax deductions for business interest expense are curtailed to business interest income plus 30% of “adjusted taxable income.” There are several exceptions, including a small business exception for companies with average gross receipts of less than \$25 million. This restriction offsets the new law’s enhanced accelerated depreciation opportunities.



## Estate tax exemption doubled

For the estates of persons dying and gifts made after December 31, 2017, the TCJA doubles the estate, gift and generation-skipping transfer tax exemption amounts to an inflation-adjusted \$11.2 million (\$22.4 million for married couples). The exemptions are scheduled to revert to their previous levels (adjusted for inflation) on January 1, 2026.

This change will ease the cost of succession for some family-owned construction businesses. It also creates opportunities to take advantage of temporarily increased exemptions by making large lifetime gifts or establishing “dynasty” trusts.

## Accounting relief expanded

Generally, construction companies are required to account for long-term contracts using the percentage-of-completion (PCM) method, which

recognizes revenues and expenses as a job progresses. There’s an exception, however, that allows certain companies with average annual gross receipts of \$10 million or less in the preceding three years to use the completed contract method (or another permissible alternative). The completed contract method allows you to defer taxable income until a job is substantially complete.

The TCJA increases the gross receipts threshold to \$25 million. It also allows companies whose gross receipts are below that threshold to use the cash method of accounting for tax purposes and to avoid certain inventory and capitalization requirements.

## Opportunities abound

Now that the new year is underway, it’s important to dig deep into the TCJA’s provisions and identify tax-planning opportunities for 2018 and the years ahead. ■

## 3 tips for dealing with design issues

**T**raditionally, a contractor's role is to build — that is, to implement a design created by an architect or other design professional. But given the vagaries of the industry, it's not unusual for plans and specifications to be incomplete when construction begins. Contractors asked to help fill in these design gaps should proceed with caution. Here are three tips to consider:

**1. Understand the difference between design and performance specifications.** Owners may furnish a contractor with design specifications, performance specifications or a combination of the two. Generally, design specifications detail the materials and products the contractor must use, as well as the manner in which he or she must perform the work. Performance specifications, on the other hand, spell out a performance result to be attained and leave it up to the contractor to determine how to achieve it.

The difference between design and performance specifications is critical. Generally, a contractor won't be held responsible for defects in design specifications furnished by the owner. But when a contractor agrees to meet performance specifications, he or she may be held liable if the component or system fails to perform as promised. Sometimes a specification contains elements of both, and classifying it as "design" or "performance" depends on the contractor's level of discretion in implementing the specification.

**2. Distinguish between design and implementation.** Contractors are generally well suited to advise an owner on how to implement design or performance specifications. But it's important to avoid crossing the line into pure design territory by creating those specifications. Most contractors

lack the design expertise to do so and usually aren't insured for it. (Note: Different rules apply to design-build projects.)



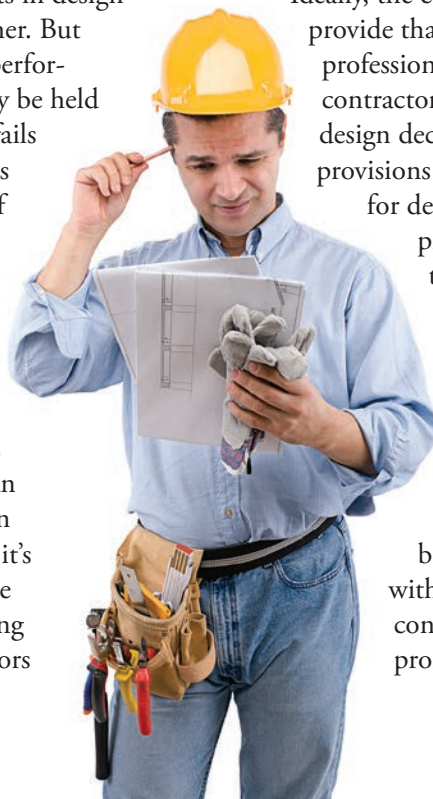
*Watch out for contract provisions that attempt to shift liability for design defects to you.*



**3. Clarify your role.** If you're asked to get involved in design issues on a project, communicate clearly to the owner and other parties that you're not a building designer and would prefer not to specifically address any design gaps. This doesn't mean you still can't share your experiences working on similar projects and dealing with pertinent building components. Just be sure to keep everyone's roles and responsibilities clear.

Ideally, the contract documents should provide that the owner and/or design professional — and not, you, the contractor — is responsible for all design decisions. Watch out for contract provisions that attempt to shift liability for design defects to you. For example, a contract might require the contractor to notify the owner of any design defects it identifies, or reasonably should have identified, in the plans or specifications.

If you're feeling uncertain about your role, responsibilities and potential liability with respect to design issues and contract provisions, consult your professional advisors. ■



# Exploring the many facets of an ESOP

**M**ost construction company owners want to retire someday, and just about every contractor is looking for ways to improve employee engagement and retention. One ambitious and somewhat complex way to do it all is by offering an employee stock ownership plan (ESOP).

## Establish a trust

An ESOP is a type of employee benefit plan, similar in many ways to a profit-sharing plan. To set up an ESOP, a company establishes a trust fund and contributes either new shares of its own stock or money to buy existing shares. The shares in the trust are then allocated to individual employee accounts (based on compensation or a formula that considers tenure), and the employees become vested in the accounts over a specified period of service years.

One reason for companies to establish an ESOP is to buy the shares of an owner who wants to retire. In many closely held or family-owned businesses, including construction companies, there isn't a family or staff member who's capable of or interested in taking over when the founder is ready to leave. In such cases, the company can make tax-deductible contributions to an ESOP to buy the owner's shares or have the ESOP borrow money to buy shares. Either way, the company enjoys tax advantages while helping to deal with the succession issue.

A retiring owner who's cashing out over time or has lost money to the ESOP will often keep a seat on the company board and retain voting rights during the transition. In this manner, businesses with an ESOP are often better able to keep valuable and experienced staff on board through ownership changes. In addition, an ESOP can serve to motivate staff because they're part owners.

## Think about taxes

The tax advantages of ESOPs are considerable. All contributions to the plan are tax-deductible,



including shares of stock, cash contributions (whether they're used to buy stock or to build up a cash reserve) and any payments made to repay loans taken out by the ESOP.

In addition, in C corporations, sellers are eligible for a tax deferral. If certain conditions are met (say the seller has held stock for at least three years and the ESOP owns at least 30% of shares), the seller can reinvest sales proceeds in qualified replacement property (generally, domestic stocks and bonds) and defer taxes on the gains as long as the rollover is executed within a specified time.

In S corporations, the percentage of ownership held by an ESOP is tax-exempt at the federal and usually at the state level as well. When an ESOP holds 30% of an S corporation's stock, 30% of profits are tax-exempt. When the ESOP holds all of the S corporation's stock, there's no income tax owed on any of the company's profits.

Last, ESOPs are allowed to borrow. When the plan does so to buy new or existing shares, the company can then make tax-deductible contributions to the ESOP in repayment. In such a case, both principal and interest are deductible.

## Assess the risks

ESOPs incur considerable start-up and maintenance costs that can run into tens of thousands

of dollars, even for small businesses. Midsized to larger companies may face even higher expenses based on the complexity of the arrangement.



*The company or ESOP must maintain enough liquid assets to repurchase the shares of employees who leave.*



A greater potential risk is the pool of money needed to buy back shares of departing employees at fair market value. If the ESOP can't do so, the company (as plan sponsor) must buy the shares.

So the company or ESOP must maintain enough liquid assets to repurchase the shares of employees who leave. If the stock price appreciates substantially, doing so can be a tall order for contractors, who commonly face cash-flow dilemmas associated with the unpredictable nature of construction projects and backlog.

An ESOP can also substantially affect your bonding capacity. So be sure to consider these risks with your surety representative before creating an ESOP.

### Discuss in detail

Yes, ESOPs are a many-faceted thing. And establishing one isn't in the best interests of every construction company. But if you're intrigued by the concept, contact your CPA for further details. ■

## We're covered, right?

Additional insured provision doesn't guarantee protection

**C**onstruction subcontracts often contain "additional insured" provisions. This legal language requires a subcontractor to name the owner, general contractor (GC) and higher-tier subcontractors (if applicable) as additional insureds under the subcontractor's commercial general liability (CGL) policy.

These provisions are designed to protect the other parties from liability in connection with the subcontractor's activities on the project. But the existence of such a provision is no guarantee that you're protected. A recent federal appeals court case illustrates the dangers of assuming you're covered without studying the relevant policies.



### Details of the case

In *Cincinnati Insurance Co. v. Harleysville Insurance Co.*, a sub-subcontractor's employee was injured while working on a construction project and sued the owner, the GC and the subcontractor. The contract between the subcontractor and sub-subcontractor required the sub-subcontractor to name these parties as additional insureds. The

sub-subcontractor's CGL policy, however, contained a "Privity Endorsement," which essentially limits additional insured status to parties with whom the sub-subcontractor contracts directly — in this case, the subcontractor.

The owner and GC claimed that they were entitled to additional insured coverage under the sub-subcontractor's policy, but the U.S. Circuit Court of Appeals for the Second Circuit disagreed. Although the sub-subcontractor's failure to obtain insurance for the owner and GC as additional insureds may constitute breach of contract, the court said, "... the validity of such a claim does not modify the insurance policy to say something that it does not." Provisions in a construction contract don't affect the terms of a policy that's "complete and clear and unambiguous on its face."

The court also rejected the argument that an "Automatic Status Heading" in the policy overrode the Privity Endorsement. The Automatic Status Heading provided that "owners, lessees, or contractors are automatically entitled to additional insured status when required in a construction agreement with [the sub-subcontractor]." But to accept the argument that the Automatic Status Heading governs interpretation of the policy would have rendered the Privity Endorsement meaningless. The court observed that the Privity Endorsement itself cautioned the parties, "This endorsement changes the policy. Please read it carefully."

### **No assumptions**

To determine whether you're covered as an additional insured under another party's CGL policy, review the policy itself and carefully examine any Privity Endorsements or other provisions that affect additional insured status. Don't assume you're protected simply because the other party is contractually obligated to name you as an additional insured. And don't rely on certificates of insurance. Rather, you should request a certified copy of the policy and scrutinize the relevant language.



Beware that the scope of coverage extended to additional insureds may be narrower than that provided to the policyholder. For instance, some policies limit coverage for additional insureds to personal injuries or property damage for which the policyholder is at least partially responsible. In other words, coverage may be denied if the additional insured is solely responsible. Also, some policies exclude additional insured coverage for claims that arise after the project has been completed.

### **Scope and relevance**

Before you enter into a construction contract, be sure you understand the scope of all relevant insurance policies and the level of additional insured protection provided by other parties' policies. Your insurance broker can help verify your insured status and review your options in the event coverage is insufficient. ■



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## Success-building services for contractors

Since 1974, E.F. Alvarez & Company, P.A., has excelled in providing accounting, tax and consulting services that help construction companies throughout South Florida increase their profitability and success.

We not only understand the challenges contractors face, but also are familiar with the obstacles their sureties must overcome in the underwriting process. In addition, our highly skilled staff offers accounting and forensic investigative expertise in matters involving employee dishonesty, construction contract claims, and other types of surety and fidelity claims.

Our firm maintains the highest standards of integrity and professionalism, and consistently delivers cost-effective services that exceed our client's expectations. We are prepared to help you in the following areas:

- Audits and reviews
- Tax planning and compliance
- Surety consulting
- Banking relationships
- Merger and acquisitions
- Business valuations
- Claims and change orders
- Forensic accounting/litigation support
- Management consulting
- Software selection/implementation
- Equipment cost allocations
- Job costing
- Estate and continuity planning
- Due diligence

For over 42 years, Emilio F. Alvarez, the firm's founder, has been a reliable and trusted advisor to many contractors and surety companies around the country. Following is a list of some of his professional achievements:

- Past Chairman of the National Construction Industry Conference Steering Committee of the American Institute of CPAs.
- Member of CICPAC (Construction Industry CPAs Consultant Association)
- Member of the Tax and Fiscal Affairs Committee of AGC (The Associated General Contractors of America)
- Member of the Construction Industry Conference Committee of the Florida Institute of CPAs
- Member of CFMA (Construction Financial Management Association)
- Member of the American Institute of CPAs
- Member of the Florida Institute of CPAs
- Financial Counsel of the South Florida Associated General Contractors
- Member of the Construction Industry Council — Florida International University
- Member of CPA Advisory Council of the NASBP

Emilio is also the author and presenter of many seminars on the subject of construction accounting and auditing to banks, sureties, governmental authorities and CPA groups.