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A CPA's Report for the Construction Industry

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Tax Reform Highlights

Big Changes for Pass-Through Businesses

One of the most talked-about provisions of the 2017 Tax Cuts and Jobs Act is the 20 percent deduction on pass-through income from sole proprietorships, partnerships, S corporations, and LLCs. Because so many construction-related businesses are organized as pass-through entities, many contractors have greeted this provision with understandable enthusiasm.

It is important to remember, however, that the 20 percent deduction is subject to some complex limitations. In addition, contractors must consider how some other elements of the new tax law will interact with the pass-through deduction.

Examples include the elimination of the corporate Alternative Minimum Tax (AMT), higher exemption levels for the personal AMT, and provisions that give small contractors more flexibility in choosing their accounting methods. Because of these interacting variables, owners of pass-through businesses will need to work closely with their accountants to apply the deduction properly.

A Closer Look at the Deduction

Starting in 2018, C corporations are taxed at a flat rate of 21 percent. But owners of pass-through entities are taxed on earnings at individual tax rates, which still could be as high as 37 percent under the new law. To balance out this disparity, the law allows sole proprietors, partners, and owners of pass-through entities to claim a below-the-line deduction of 20 percent of their net "qualified business income."

The term "qualified business income" does not include wages that are paid to S-corporation shareholders and reported on their individual Forms W-2. Rather, the deduction applies only to the S-corporation profits that are reported to shareholders on Form K-1. Similarly, qualified business income also excludes guaranteed payments associated with partnerships and LLCs.

The deduction begins to phase out if the individual's taxable income (including income from all other sources) exceeds $157,500 (or $315,000 if filing a joint return). The phaseout is calculated using several formulas that take into account the total wages paid to all employees and other factors.

What Is "Reasonable Compensation"?

While S corporation owners might be tempted to reduce their W-2 wages to create more pass-through income, they still must adhere to the IRS requirement that S corporation officers must be paid "reasonable compensation." The IRS provides only limited guidance as to what is considered reasonable, but it has developed a list of nine specific factors that U.S. tax courts have considered in such cases. These factors are

1. The duties and responsibilities of the shareholder.
2. The time and effort the shareholder devotes to the business.
3. The shareholder's training and experience.

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Construction Material Costs

Don't Let Rising Costs Eat Away Profits

Recent studies suggest that prices for construction materials are rising at a relatively moderate pace overall, but certain materials have seen sharp price increases over the past year. Careful contractors will take steps to protect themselves against price hikes that could squeeze margins on long-term projects.

The U.S. Bureau of Labor Statistics reports that the cost of construction-related materials increased by approximately 5 percent between early 2017 and early 2018. Analysts from the Associated Builders and Contractors have suggested that contractors should expect roughly similar gains over the next year or so.

But a closer look at the numbers reveals that prices for some materials—notably softwood lumber and nonferrous wire and cable—increased at two to three times the overall rate. The long-anticipated increase in infrastructure projects could put additional upward pressure on material costs, and the possibility of new tariffs on certain imported goods could increase construction material costs even further. Meanwhile, volatile prices for diesel and other fuels add even more uncertainty to the picture.

Unexpected increases in material costs can turn an otherwise profitable project into a money-loser, especially on longer-term projects that are more susceptible to price volatility. While it is impossible to eliminate price fluctuations altogether, there are some common-sense steps you can take to help limit your risk.

Contract Protections

The ideal way to minimize the risk of rising material costs is through a cost-plus contract. Of course, many project owners are reluctant to enter such a contract because it shifts all the risk of price increases from you to them. You might find a more receptive reaction if the cost-plus contract is coupled with a guaranteed maximum price, which lets both parties share some of the risk.

If a full cost-plus contract is not in the cards, you might be able to negotiate escalation clauses to help spread the risk. Escalation clauses specify a trigger price for certain key commodities (for example, copper pipe for a plumbing subcontractor). If prices escalate beyond that trigger, the general contractor (and ultimately the owner) agree to absorb a portion of the increase.

Such contract protections are not without their drawbacks. The accounting and documentation requirements can be burdensome because you might be required to show that escalating costs were outside of your control. You will need adequate administrative resources and a robust job cost accounting system to provide the required level of detail.

Sourcing and Supply Chain Management

Even when prices are stable, it is always important to be sure you are dealing with reliable, reputable, and informed suppliers. When shortages crop up, a supplier who has built up loyalty and is able to get you scarce materials can be a lifesaver.

In addition to following price projections from construction associations and industry publications, it's also good practice to talk regularly with your suppliers and manufacturers about where they anticipate prices will go. In the best-case scenario, you might be able to negotiate a price guarantee during the period covered by the contract. But even if this is not possible, maintaining good relationships with suppliers is always a sound business practice.

Maintaining Inventories

If you have a firm contract and are confident in your continued need for certain raw materials, it can make sense to purchase critical or price-sensitive commodities in advance. Sometimes this can expose you to new problems such as cash flow issues, storage costs, and the risk of loss or theft. In addition, you could find yourself in a difficult situation if the project is halted for any reason. Ideally, you would make a purchase commitment with your supplier but arrange for delivery at a later date. Suppliers might be reluctant to enter into such agreements, but if your supplier is willing, this could relieve you of the cost of storage and the risk of loss or damage before the materials are consumed.

Sudden price hikes can put even well-managed contractors and subcontractors at significant risk. Patient negotiating, clear communication, and careful attention to detail can help you limit your exposure.

Call us today to discuss how to protect your company from costly surprises.

Tax Reform for Contractors

Some Good—and Some Not So Good—News

Among the many changes that the 2017 Tax Cuts and Jobs Act ushered in, there are several provisions that are likely to benefit construction-related businesses. On the other hand, at least one change is likely to disappoint many contractors, while several other provisions that are important to the industry remain essentially unchanged.

Good News—Expensing and Depreciation Provisions

Two changes that are likely to appeal to many construction companies involve the expansion of Section 179 equipment expensing and bonus depreciation.

Section 179 allows a taxpayer to immediately deduct the cost of purchasing qualifying property—such as new or used construction equipment and vehicles—in the year the property is acquired, rather than capitalizing and depreciating it over a period of years. The new tax law increased the maximum amount that can be expensed under Section 179 to $1 million and expanded the definition of qualifying property to include roofs, HVAC equipment, and fire alarm and security systems in certain buildings.

The Section 179 deduction begins phasing out on a dollar-for-dollar basis once a business spends more than a certain amount. The new law raises that amount to $2.5 million.

Like Section 179, bonus depreciation also allows companies to immediately deduct a portion of the cost of qualifying property. But there is no spending cap, which makes it particularly advantageous for large businesses that exceed the Section 179 limits.

The new tax law temporarily increases the bonus depreciation deduction from 50 percent to 100 percent and expands the definition of qualifying property to include used property. Note, however, that bonus depreciation begins to phase out after 2022 and is eliminated after 2027.

Another provision of interest to many contractors involves the choice of accounting methods. Under the new law, small contractors with less than $25 million in gross receipts might be permitted to choose the cash method of accounting rather than the accrual method. Some also could choose something other than the percentage-of-completion method to account for revenue from long-term contracts.

These choices could simplify small contractors' tax preparation, but they need to be considered within the context of other provisions, such as compliance with the revised personal Alternative Minimum Tax (AMT) requirements.

The Not So Good News—Elimination of the DPAD

One disappointment in the new law for the construction industry is the elimination of the Domestic Production Activities Deduction (DPAD). Under Section 199 of the Internal Revenue Code, the DPAD allowed businesses to deduct a portion of the income they generated from certain domestic production activities including qualifying construction-related income.

Broadly speaking, many new U.S. construction projects qualified for the DPAD, as did many renovation projects. In some cases, the deduction amounted to as much as 9 percent of the qualified income, so its elimination is a letdown for many contractors.

Despite that disappointment, however, the Tax Cuts and Jobs Act did leave several popular construction-related tax credits unchanged. One such credit, the Work Opportunity Tax Credit, is offered to employers that hire individuals from nine target groups who traditionally face significant employment barriers. The credit could reduce a company's federal income tax liability by $1,200 to $9,600 for each eligible employee, depending on the employee's pay and hours worked.

Other tax credits that survived the tax overhaul include the Research and Development Tax Credit, the Low-Income Housing Credit, and the New Markets Tax Credit.

Our firm can help you stay abreast of the many new rules stemming from the tax overhaul. Contact us for regular updates.

Pass-Through Business Changes

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4. Payments the company provides to non-shareholder employees.
5. The timing and manner in which the corporation pays bonuses.
6. The company's dividend history.
7. What comparable businesses in the industry pay for similar services.
8. The existence of written compensation agreements.
9. Any documented formulas the company uses to determine compensation.

The more of these factors a taxpayer can demonstrate, the better the chances of convincing the IRS that officers' salaries are reasonable.

For S corporations—and all other types of pass-through entities—there are still several unanswered questions regarding the new deduction. While tax professionals urge the IRS to provide additional guidance soon, contractors whose businesses are structured as pass-throughs should continue to monitor developments and, in the meantime, take care that the salaries they pay themselves and other active shareholders will stand up to scrutiny.

The new tax law will have a major impact on every business. Please call us to schedule a review soon.

Mueller Prost
CPAs + Business Advisors

www.muellerprost.com

MISSOURI	MISSOURI	CALIFORNIA
St. Louis (main office)	**St. Charles**	**Irvine**
7733 Forsyth Blvd., Suite 1200	2460 Executive Drive	3 Park Plaza, Suite 400
St. Louis, MO 63105	St. Charles, MO 63303	Irvine, CA 92614
tel: 314.862.2070	tel: 636.441.5800	tel: 800.649.4838
fax: 314.862.1549	fax: 636.922.3139	fax: 562.624.9818

Federal Fuel Tax Credits

If your company uses off-road vehicles such as earthmoving, excavating, or loading equipment, be sure you are taking full advantage of any federal fuel tax credits that might be available. Two credits—the Alternative Fuel Excise Tax Credit and the Federal Fuel Tax Credit—are worth particular scrutiny.

Technically, the Alternative Fuel Excise Tax Credit had expired in December 2016, but the Bipartisan Budget Act of 2018, signed into law in February, extended it retroactively through the end of 2017.

The act provides a 50 cent per gallon tax credit for the use of various alternative fuels, including liquefied petroleum gas (LPG) or propane. Your company could be entitled to this credit for propane used in forklifts or other off-road vehicles, but you must register with the IRS to claim it.

Although technically it has expired again, the credit is one of several so-called "extenders," which

are routinely—and often retroactively—approved by Congress every year. There are no guarantees, but another extension is considered likely next year.

Your company could be eligible for another federal tax credit if you use diesel-powered off-road equipment. Fuel distributors collect a federal excise tax of 24.4 cents per gallon on clear diesel fuel, but no tax is collected on diesel that is dyed red and intended for off-road use only.

Large fuel distributors are usually careful to distinguish between the two types of diesel but, if for any reason, you end up using clear diesel in off-road equipment, you could be eligible for a refund of the federal excise tax you paid. You will need good records to support your claim, which is filed either annually or quarterly, depending on the size of your claim.

For more information on available tax credits, please call us to schedule an appointment.