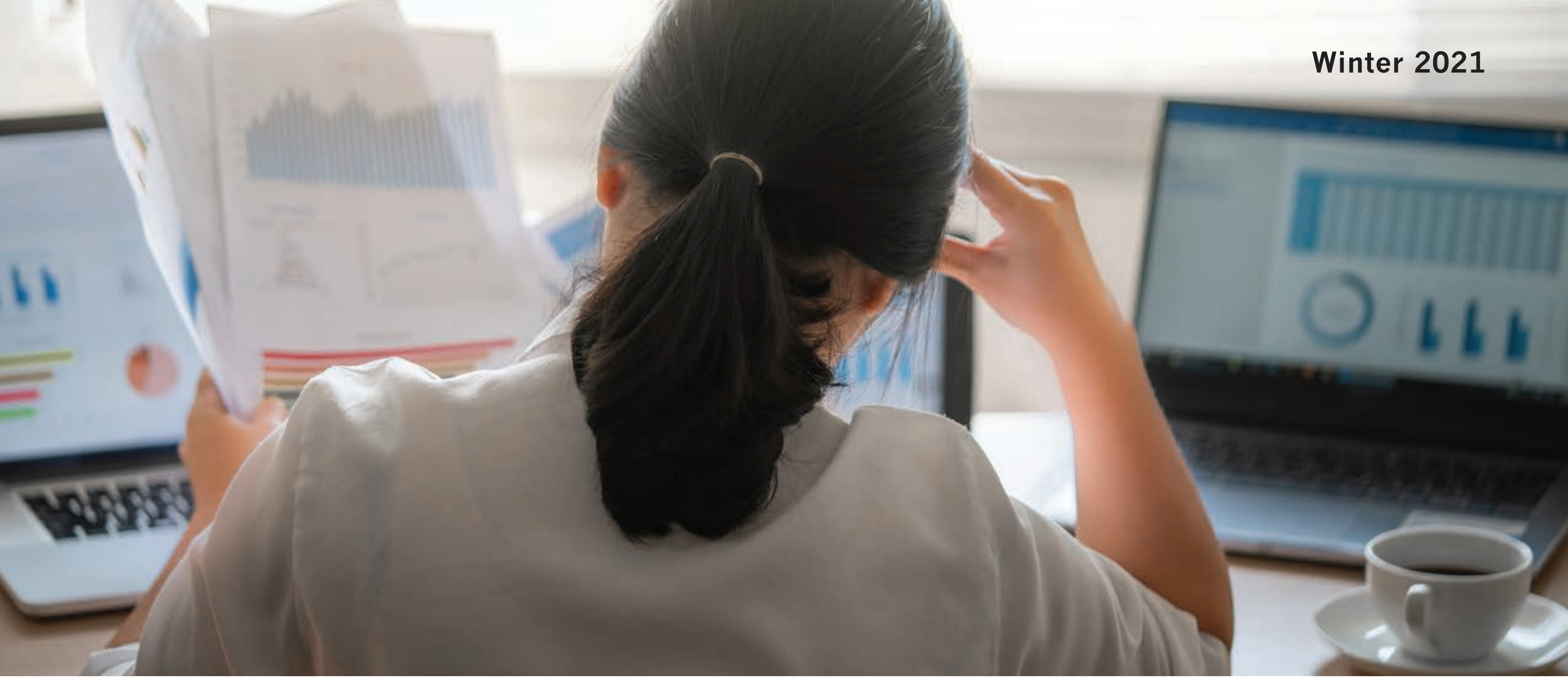

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CONSTRUCTION INDUSTRY ADVISOR

SMITH, KESLER & COMPANY, P.A.
CERTIFIED PUBLIC ACCOUNTANTS
COVERING THE CAROLINAS

Qualified improvement property

Beware of a potential tax trap

In the current economic environment, cash flow is a precious commodity. Construction companies need to make the most of depreciation deductions that can reduce their tax bills. Fortunately, several provisions of the CARES Act can help you do just that.

One of these provisions fixed a technical glitch, retroactive to 2018, that deprived many taxpayers of 100% bonus depreciation for qualified improvement property (QIP). This is good news for commercial property owners that invested in eligible building interior improvements over the last three years.

However, it also sets a dangerous tax trap for those that elect not to claim bonus depreciation for QIP — potentially resulting in the permanent loss of future depreciation deductions.

What is QIP?

Generally, improvements to nonresidential commercial buildings are depreciated over 39 years, which is the depreciable life of the real property being improved. But, in recent years, Congress has allowed taxpayers to depreciate improvements to certain types of property more quickly.

Until 2017, these included qualified leasehold improvement, restaurant and retail improvement properties. However, that year, in the Tax Cuts and Jobs Act (TCJA), Congress eliminated those categories in favor of a single category — QIP — effective in 2018.

QIP is an improvement made by a taxpayer to the interior of an existing nonresidential building, including installation or replacement of:

- Drywall,
- Ceilings,
- Interior doors, fixtures and plumbing, and
- Mechanical, electrical and fire protection systems.

Certain improvements are excluded from the definition of QIP, including enlargement of a building and improvements to elevators, escalators or the internal structural framework.

What was the glitch?

Congress intended to establish an accelerated, 15-year depreciable life for QIP. This would have made it eligible for 100% bonus depreciation, which is available for depreciable assets with a recovery period of 20 years or less. But the TCJA inadvertently classified QIP as 39-year property, making it ineligible for bonus depreciation.

By correcting this error, the CARES Act allowed commercial property owners to claim significant bonus depreciation deductions for building improvement expenses. And, because the fix was retroactive to the beginning of 2018, it provided an opportunity for owners that made such improvements in 2018 and 2019 to amend their returns for those years, claim the deductions they missed, and seek a refund of any tax overpayments. Alternatively, some owners may be able to file Form 3115 (“Application for Change in Accounting Method”) and claim “catch-up” deductions.

Due date for amended returns

If you're considering filing an amended return for 2018 or 2019, be sure you know when it's due. Generally, an amended return that results in a tax refund is due by the later of:

- Three years after the original return was timely filed (including extensions), or
- Two years after the tax was paid.

So, for example, if you filed and paid your 2018 tax return by its April 15, 2019, due date, the due date for an amended return would be April 15, 2022 — even if you filed your original return early. Note: If you obtained an extension to October 15, 2019, but filed your return before that date, the due date for an amended return would be three years from the actual filing date.

Where's the trap?

The technical correction made by the CARES Act created a potential tax trap for owners that placed QIP in service in 2018 or 2019 but choose not to claim the depreciation deductions they missed in those years.

There are several possible reasons for doing so. Some commercial property owners, depending on their tax situations, may enjoy little or no benefit from additional depreciation deductions in those years. Others may want to avoid the administrative complexity and expense associated with amending previous tax returns — especially if they're structured as partnerships or S corporations. Or perhaps reducing taxable income in a previous year would have a negative impact on other tax benefits.

Whatever the reason, failure to act can lead to unwelcome tax consequences. Why? Because the IRS now views depreciation of QIP placed in service after 2017 using a 39-year recovery period as an impermissible accounting method. Moreover, 100% bonus depreciation is mandatory for QIP unless a taxpayer opts out in favor of depreciation over 15 years.

Here's the problem: The tax code and regulations require you to reduce the basis of depreciable property by the amount of depreciation that's "allowed or allowable," regardless of the actual amount of depreciation you claim. So, for example, if you placed QIP in service in 2018 and didn't opt out, you must reduce its basis by 100% to reflect allowable bonus depreciation — even if you've been depreciating the property over 39 years.

If you're required to reduce the depreciable basis of QIP by the amount of previously allowable but unclaimed bonus depreciation, you lose the ability to claim that depreciation in the future. In addition, should you sell the property, you may owe taxes on recaptured depreciation deductions that you never used.

What's the next step?

If your construction company owns commercial property, placed QIP in service in 2018 or 2019, and has been depreciating it over 39 years, doing nothing isn't an option. To avoid the potentially costly tax trap, file the necessary paperwork with the IRS to either 1) claim missed 100% bonus depreciation deductions for those years, or 2) opt out of bonus depreciation and claim the additional depreciation deductions you would have taken had you used a 15-year recovery period.

In the case that your construction business doesn't own property, you might be able to build goodwill with clients by informing them of the QIP tax trap. Contact your CPA for more information. ■

Connecting your succession plan to your estate plan

For any business owner, contractors included, putting together a succession plan may seem like an overwhelming task. Often, among the most difficult things to conceptualize is precisely how to connect — and beneficially integrate — your succession plan with your estate plan. Here are a few ideas to consider.

Sell your shares

By selling your ownership interest, you remove its potential future appreciation from your estate and receive income either in the form of a lump sum that you can invest or periodic payments on an installment note.

You'll likely need many years to transfer an entire construction business by making annual exclusion gifts.

Sometimes, a sale may be structured to take advantage of lower long-term capital gains rates, and creative financing can be used to help the next generation to make the purchase. Often, however, the tax impact or a lack of liquidity on the part of the buyer makes a "straight sale" unappealing and makes it worthwhile to consider another method for transferring ownership.

Gift your interests

If your succession plan involves family members, annual exclusion gifts are another option. You can gift $15,000 per recipient per year gift-tax-free

($30,000 if you combine gifts with your spouse) and without using up any of your $11.7 million (in 2021) combined gift and estate tax exemption.

Annual exclusion gifting also can help preserve your gift and estate tax exemption because the exemption available at death is effectively reduced by the amount of taxable gifts you make during life, but not by annual exclusion gifts. Nonetheless, there's nothing wrong with using some or all your gift tax exemption — especially if you're removing from your estate a potentially rapidly appreciating asset.

You may be able to further leverage the gifts with valuation discounts. For instance, you may be able to claim that the gift of a minority interest is worth less than its share of the underlying value of the assets, thereby allowing you to transfer a larger proportionate interest tax-free. But discounts also may trigger IRS scrutiny regarding whether they're too big or warranted at all.

Another potential disadvantage is that, making annual exclusion gifts, you'll likely need many years to transfer an entire construction business. Thus, many business owners use annual gifting only in conjunction with other methods.

Create a trust

Trusts can often provide the most appropriate means for transferring a business. In succession planning, one common vehicle is the grantor retained annuity trust (GRAT). This is an irrevocable trust that can be funded with your construction company stock and from which you receive an annuity (calculated using the IRS's Section 7520 rates) for a term of years.

Funding a GRAT creates a taxable gift (and possible use of your lifetime exemption) to the extent that the value of the assets contributed exceeds the current value of the annuity payments due back to you.

The tax leverage of a GRAT comes in two ways. First, you gain tax leverage if an appraisal on funding supports a discounted value of the stock, allowing you to transfer more shares at the same gift tax price. Second, fewer and fewer shares of stock are needed to be paid back to the grantor to fund the annual annuity payments to the extent the company stock appreciates at an annual rate greater than the Sec. 7520 rate.

The fewer the shares needed to fund the annuity, the more shares will be left in the trust to pass free of estate tax to the GRAT's beneficiaries. If you die before the expiration of the term, however, the entire GRAT is pulled back into your estate, thereby nullifying its tax advantages.

Plan carefully

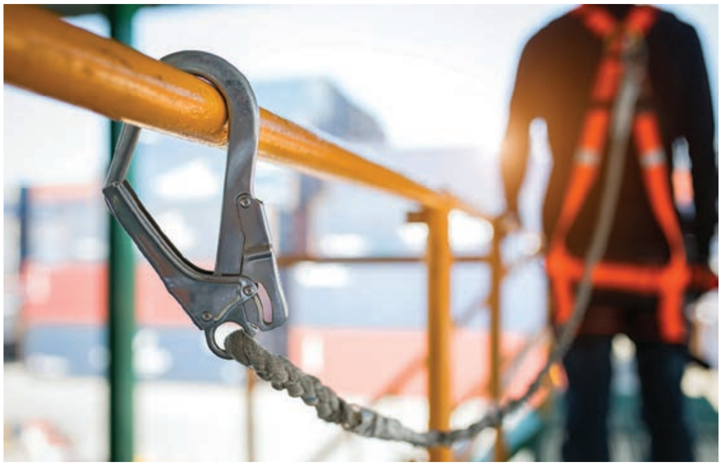
Many construction company owners spend a long time, even a lifetime, building up the value of their businesses. Be sure to plan carefully how you'll pass along that value when you're ready to retire or otherwise move on. Your CPA can be of invaluable assistance in crafting both a succession plan and an estate plan. ■

5 tips for reducing workers' compensation costs

For most construction businesses, workers' compensation insurance is a significant expense. Here are five tips for reducing or at least better controlling these costs:

1. Make sure employees are classified properly. Workers' compensation insurers assign risk classification codes to employees based on their duties, responsibilities, and level of exposure to the risk of injury or illness. Higher risk means higher premiums, so be sure that employees are classified properly. If an employee who now works in the office (or from home) is still classified as an on-site laborer, your premiums may be needlessly inflated.

2. Double-check your experience modification rate. Used to calculate workers' compensation insurance premiums, this rate — also known as the



experience modifier — represents your company's loss history relative to industry average.

If you have an average loss history, your experience modifier will be 1.0. A higher-than-average loss history will raise your modifier above 1.0, increasing your premium; a lower-than-average loss history will have the opposite effect. Find out how your insurer determines its modifier and verify that the calculations are accurate.

3. Develop a robust safety program. The most effective way to reduce workers' compensation costs is to avoid accidents and injuries. That's why it's critical to develop a solid safety program that follows the Occupational Safety and Health Administration's construction industry standards.

Train new hires thoroughly on safety protocols and procedures, as well as on the proper use of any construction equipment they'll be using. From there, provide ongoing training and education as much as possible. Once your program is up and running, review and evaluate your safety performance regularly and update the program as necessary.

4. Promote a culture of safety. Even the strongest safety standards are effective only if they're followed and enforced, so it's essential to make safety a part of company culture. This means setting the tone at the top and communicating to employees the importance of not only following safety guidelines, but also reporting accidents or injuries promptly. If employees are hesitant to report injuries, or feel pressure to "work through the pain," your workers' compensation claims will likely balloon both in number and magnitude eventually.

Building a safety culture involves sound hiring and training processes, too. By discussing your company's expectations regarding safety during interviews, you can get a feel for an applicant's proclivity for risky behavior. Training should emphasize safety practices and, as mentioned, underscore the importance of prompt reporting of accidents and injuries.

5. Establish a return-to-work program. As the amount of time injured workers are off the job increases, their claims for lost wages will also go up while the likelihood of their return diminishes. A formal return-to-work program can help you retain employees and control workers' compensation claims.

The most effective way to reduce workers' compensation costs is to avoid accidents and injuries.

These programs help reintegrate injured workers into the workforce as soon as possible, typically in less physically demanding roles and often on a part-time basis. If an employee earns less than his or her preinjury wages during this period, the workers' compensation insurer may make up the difference. The result: Injured workers return to their regular duties more quickly, reducing the costs of claims and minimizing the impact on your premiums.

Is blockchain the future of construction?

Blockchain is the technology that powers Bitcoin and other cryptocurrencies, but its value extends far beyond the world of finance. Although this technology may not be ready for prime time in construction just yet, industry experts recognize its promise to transform the way projects are managed.

Simple concept

The technology behind blockchain is sophisticated. The concept, however, is simple: It's a shared database — or "digital ledger" — that's continuously copied, updated and synchronized on thousands or even millions of computers maintained by various third parties.

This lack of centralized storage or control makes it extremely difficult for anyone to hack into or tamper with the database/ledger, which can accept new transactions only if they're verified by these third parties through established consensus protocols.

Smart contracts

Blockchain's ability to produce validated, immutable records that are readily available to all parties helps establish trust while minimizing the need for intermediaries to authenticate or certify transactions.

Consider "smart contracts," for example. By using blockchain to create and execute construction contracts, the parties can ensure that they're literally on the same page. The technology eliminates confusion by maintaining only one version of the contract, which is virtually impossible for someone to modify without triggering all sorts of alarms. If a change or correction is required, it can be added to the blockchain, together with appropriate explanations and supporting documentation, creating a permanent audit trail.

Smart contracts can also be used to automate processes, cutting out the "middleman" and avoiding delays. Suppose a construction company has engaged a vendor to supply certain building materials to its projects. If the vendor affixes radio frequency identification tags to the materials as they're shipped, the parties can track their movement and determine when they've been delivered to a job site.

Once the materials have been inspected and approved (using a digital signature), the smart contract determines whether the vendor has delivered the materials on time and met any other contractual terms. If so, the system initiates an electronic payment to the vendor. If the vendor fails to meet contractual requirements, the smart contract documents this fact, alerts the parties and can even track the delay's impact on related construction activities.

No limits

Blockchain has the potential to automate, record and track a variety of job-related transactions. At some point in the future, it could ensure prompt payment of contractors and subcontractors, enhance transparency, prevent delays, and minimize disputes. In other words, blockchain's potential is virtually unlimited. Keep an eye out for it to become more commonly used in years ahead.

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