February 2019

Make and Save Money in 2019

Welcome to the February 2019 issue of MCC Construction Zone! Although the temperature has been cold for most of the winter thus far, things are heating up in the construction industry. 2018 ended on a high note and it is expected that we will continue to see more of the same in 2019.

We address several key issues for most construction contractors in this newsletter. These include the tax treatment of qualified improvement property, new rules and "safe harbors" for pass-through entities, employee engagement, and retirement planning. We also spotlight Don Kaiser, CPA, principal in our New Jersey office. Our goal is to provide guidance on making and saving money in 2019. Happy reading!

Marty McCarthy, CPA, CCIFP
Managing Partner
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Construction Spending Increased in 2018: *Spending was 4.5% higher through November 2018 than during the same period in 2017.*

By David E. Gibbs, CPA, CCIFP, MBA

Construction spending rose 0.8% to a seasonally adjusted annual rate of $1.3 billion in November from a revised $1.29 billion in October. The Commerce Department reported

in its *Monthly Construction Spending Report* for November 2018, that the housing sector was responsible for most of this growth.

Andrea Riquier states in her article entitled *Construction Spending Ticks Up, Led by Housing,* published on February 1, 2019 on MarketWatch: "Economists surveyed by Econoday had forecast a 0.2% increase, but October figures were revised down to $1.23 billion. Outlays in November were 3.4% higher than a year ago, and for the first 11 months of 2018, they were 4.5% higher than the same period in the prior year."

The *Monthly Construction Spending Report* stated that for November, overall private-sector spending was at $993.4 billion, 1.3% higher than the revised October estimate of $980.4 billion. Residential construction spending was at a seasonally adjusted rate of $524.2 billion in November, 3.5% above the revised October estimate of $524.2 billion. Nonresidential construction was at a seasonally adjusted annual rate of $450.8 billion during the same period, 1.2% below the revised October estimate of $456.1 billion.

The seasonally adjusted annual rate of public construction spending was $306.5 billion, 0.9% below the revised October estimate of $309.3 billion. Highway construction was at a seasonally adjusted annual rate of $93.4 billion, 1.7% above the revised October estimate of $91.8 billion. Educational construction did not fare as well. It was at $76.7 billion, 2.0% below the revised October estimate of $78.3 billion.

According to the Employment Situation Summary published on February 1, 2019 by the Bureau of Labor Statistics, construction employment rose by 52,000 in January. Job gains occurred among specialty trade contractors, with increases in both the nonresidential (+19,000) and residential (+15,000) components. Employment also rose in heavy and civil engineering construction (+10,000) and residential building (+9,000). Construction has added 338,000 jobs over the past 12 months.

As reported in the article entitled *The 2019 Construction Outlook* published in the November 2018 issue of *MCC Construction Zone*, many experts expect a decline in construction spending in 2020. Robert A. Murray, chief economist for Dodge Data & Analytics, claims that "this decline won't have a pronounced impact on the construction industry for at least a year. Basically, the levels of activity we're expecting in 2019 are not that different than what we saw in 2018."

Our construction services team watches economic and industry trends to ensure that the advice we give you is based on current information. Please feel free to call any member of our team at 610.828.1900 (PA) or 732.341.3893 (NJ) to discuss your situation. We are always happy to help.

About the Author

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David Gibbs, CPA, CCIFP, MBA is McCarthy & Company's tax partner and manages the day-to-day operations of the firm. He has initiated numerous processes and procedures to ensure that the work produced by McCarthy & Company is consistently of the highest quality. David holds the well-respected Certified Construction Industry Financial Professional (CCIFP) designation from the Institute of Certified Construction Industry Financial Professionals (ICCIFP).

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The Tax Treatment of Qualified Improvement Property: *Section 179, Bonus Depreciation and Cost Segregation Studies*

By Marty McCarthy, CPA, CCIFP

The Tax Cuts and Jobs Act (TCJA) of 2017 changed some widely used deductions for purchases of qualified property. TCJA consolidated the three categories of qualified real property into one qualified improvement property (QIP). The class lives of QIP should have been defined under TCJA to determine its bonus depreciation eligibility. Although it is likely that Congress intended to make QIP eligible for a 15-year modified accelerated cost recovery system (MACRS) class life and 20-year alternative depreciation system (ADS) class life, the link was omitted in TCJA making its depreciation eligibility uncertain.

MACRS is a depreciation system which allows the capitalized cost basis of assets to be recovered over a specified life of the asset by annual deductions for value depreciation. ADS is a depreciation schedule with a longer recovery period that generally better mirrors the asset's income streams than declining balance depreciation.

The uncertainty of the class life of QIP directly affects anyone in a real property trade or business (RPTB) with average gross receipts of $25 million over the prior three years. This is due to the interplay between 100% bonus depreciation and the new rules limiting business interest. RPTB includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Business interest deductions after December 31, 2017, are limited to the sum of business interest income plus 30% of adjusted taxable income (computed before allowable deductions for interest, depreciation, amortization, depletion, net operating losses, and the pass-through entity deduction). A RPTB can elect out of the business interest limitation rules and deduct all its business interest expenses. In this case, the RPTB is generally required to depreciate any residential rental property, nonresidential rental property, and QIP using the ADS method, and with lives of 30 years, 40 years, and 20 years respectively. The ADS method prohibits the use of bonus depreciation. A RPTB could also elect to submit to the business interest limitations. In this case the RPTB could take 100% bonus depreciation on its QIP plus land improvements or other personal property building components on MACRS property with recovery periods of 20 years or less.

Because of the Congressional oversight in failing to define QIP as property qualifying for a 15-year MACRS class life and a 20-year ADS class life, QIP is currently not available for 100% bonus depreciation, and must be depreciated over 39 years. Businesses with property placed in service between September 27, 2017, and December 31, 2017, must use the prior definitions of qualified leasehold improvements, qualified restaurant property, qualified retail improvement property, and qualified improvement property. After December 31, 2017, such property is classified as QIP under TCJA and is subject to the 39-year depreciation period with no bonus depreciation available.

Section 179 and Bonus Depreciation Under TCJA

IRS code Sections 179 and 168(k) (bonus depreciation) allow for the immediate deduction of part or all the cost of qualified property. TCJA changed the limits for the deductions allowed under both code sections.

The maximum annual Section 179 deduction increased from $500,000 to $1 million for qualified property placed in service after December 31, 2017. TCJA increased the annual

phase-out threshold from $2 million to $2.5 million. The Section 179 deduction begins to phase out dollar-for-dollar after $2.5 million is spent on qualified property.

TCJA expanded the definition of qualified real property eligible for code Section 179 to include the following improvements to nonresidential real property after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Bonus depreciation allows for the faster deprecation of assets with class lives of 20 years or less. The deduction for bonus depreciation increased from 50% to 100% and TCJA extended the phase-out period. A 100% first year deduction is allowed for qualified property placed in service after September 27, 2017, and before January 1, 2024. The deduction will start phasing out in 2024, going down to 80%, with a decrease of 20% for each year after that, until it phases out completely in 2026.

Depreciation of Dismountable Wall Systems

Since the IRS classifies dismountable walls as furniture and fixtures (asset class 00.11: nonstructural component of a building), the cost can be depreciated over 7 years under MACRS instead of 39 years.

Dismountable walls generally qualify for the Section 179 deduction. The combination of the Section 179 tax deduction with bonus depreciation may allow a company to expense 100% of a dismountable wall's cost in the first year it is placed into service (if it is done after September 27, 2017, and before January 1, 2023). The bonus depreciation percentage for qualified property acquired before September 28, 2017, and placed in service before January 1, 2018, remains at 50%. Special rules apply for longer production period property.

Under Section 179 rules, qualifying assets that cost under $500,000 can be written off 100% in the first year. A bonus deprecation deduction can be used for assets costing more than $500,000. Companies can benefit from both Section 179 and the bonus depreciation deduction, regardless if they pay cash or finance an asset.

Section 179 and bonus depreciation deductions are treated differently at the state level. Some states eliminated these deductions. Instead they have a more traditional depreciation deduction. Other states use a combination of these deductions and depreciation deductions. A few states have not decided on what approach to take. Therefore, it is advisable to check the depreciation laws in each state in which you do business to ensure that you are in compliance.

QIP and Cost Segregation Studies

Since Congress did not define the class lives of QIP under TCJA, a contractor may think that their only option is to depreciate a QIP as a 39-year property. There is, however, another possible way to accelerate the depreciation of the asset. A Cost Segregation Study combines accounting and engineering techniques to identify building costs that are properly allocable to tangible personal property rather than real property. This could potentially allow you to accelerate depreciation deductions, thus reducing taxes and boosting cash flow.

A Cost Segregation Study allocates the purchase price or costs to construct a building into various components to separate assets with depreciable lives of 5, 7, or 15 years from the building, which would be depreciated over 27.5 or 39 years.

TCJA made Cost Segregation Studies even more valuable than they were before. Under TCJA, a taxpayer can now take bonus depreciation on "used" assets. Assets with depreciable lives of less than 20 years generally may now qualify for bonus depreciation.

For assets placed in service after September 27, 2017, bonus depreciation is 100% (special rules apply for binding contracts executed prior to that date). Bonus depreciation was 50% on assets placed in service before September 27, 2017.

As a result of a Cost Segregation Study, an asset with a life less than 20 years can be fully expensed in the year the asset was placed in service or the year the Cost Segregation Study was completed provided it was done in a subsequent year.

Most providers of cost segregation services do not charge for estimates to determine the potential savings.

Contractors have a lot to consider with regards to the tax treatment of QIP. It is advisable to run different scenarios to determine which option will provide the best benefit.

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Marty McCarthy, CPA, CCIFP, is the managing partner of McCarthy & Company, PC. Marty is well respected by sureties and bankers for the high quality of his work and profound understanding of the construction industry. Marty helps clients by providing them with the insight needed to grow their business.

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IRS Issues New Rules and "Safe Harbors" for Pass-Through Deductions

By Jackie Himes, CPA

Thanks to the Tax Cuts and Jobs Act (TCJA) of 2017, real estate investors and other professionals may qualify to take up to a 20% deduction on income from pass-through entities. The IRS released Notice 2019-07 which created a safe harbor and more clearly defines the types of rental real estate that qualifies for the Section 199A deduction.

InvestingAnswers defines a pass-through entity as a special business structure that is used to reduce the effects of double taxation. Pass-through entities don't pay income taxes at the corporate level. Instead, corporate income is allocated among the owners, and income taxes are only levied at the individual owners' level.

Pass-through entities include the following business structures:

- Sole proprietorship
- Partnership
- Limited Liability Company (LLC)
- Single Member Limited Liability Company
- C corporation
- Professional or Personal Service Corporation
- S Corporation

Taxpayers who own a stake in any one of the above-mentioned entities, may be able to take a qualified business income (QBI) deduction from the pass-through. Taxpayers in the top federal tax bracket of 37% that qualify for the full deduction could effectively reduce their tax rate to 29% on this category of income.

The intention of the pass-through deduction was to create parity between pass-through entities and corporations, which saw a decrease in their tax rate from 35% to a flat 21%,

Real Estate Investment Trusts (REIT) generally qualify for the full 20% deduction for dividend income, with no limitation for publicly-traded and non-listed REITs.

The IRS wants to use this deduction for QBI instead of other types of income to weed out some passive investors. The original intent of TCJA was to create deductions for individuals or businesses that would result in job growth, as well as business or real estate reinvestment.

Taxpayers who are under the cap for personal income ($315,000 for married couples filing jointly and $157,500 for individuals) may also qualify for this deduction. These taxpayers are generally eligible to take the full 20% deduction if they receive QBI for rental property from an approved trade or business.

Solely for the purposes of section 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
- For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed (as described in Notice 2019-07) per year with respect to the rental enterprise.
- For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described in Notice 2019-07) per year with respect to the rental real estate enterprise; and
- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: hours of all services performed; description of all services performed; dates on which such services were performed; and who performed the services. Such records are to be made available for inspection at the request of the IRS.

The safe harbor is not the only way to qualify for the 20% QBI deduction. Pass-through entities involving rental real estate that are recognized as a trade or business (Section 162 trade or business), may also be eligible for the 20% deduction (limitations apply). Rental services for purpose of this revenue procedure include:

- Advertising to rent or lease the real estate,
- Negotiating and executing leases,
- Verifying information contained in prospective tenant applications,
- Collection of rent,
- Daily operation, maintenance and repair of the property,
- Management of the real estate,
- Purchase of materials,
- Supervision of employees and independent contractors.

There is a higher “phase-out” level and more limitations for individuals above the income threshold ($315,000 for married couples and $157,500 for individuals).

We expect that the IRS might issue further guidance on who qualifies for the 20% pass-through deduction and the safe harbor. We will let you know when more information is available.

Jackie Himes, CPA

About the Author

Jackie Himes, CPA, director - tax services, prides herself on being attentive, responsive, and proactive. As a result, her clients are confident that

she has their best interests in mind and know that their taxes are being handled by a professional who knows what she is doing. Jackie is solutions-focused while also being transparent.

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Engage Your Team to Increase Your Profits

By Marty McCarthy, CPA, CCIFP

"You don't build a business, you build people, and then people build the business."

Doc Fails

Productivity improvements in the construction industry have flatlined in recent decades compared to other industries like information technology, manufacturing, and agriculture. PlanGrid and FMI conducted a study in April 2018 of more than 600 owners of construction companies globally. According to their report on the findings, "Construction Disconnected," it's estimated that construction teams in the U.S. lose $177 billion in non-productive labor activities.

The survey respondents indicated that they spend only 11.2 hours per week on optimal activities including project execution and coordination, 8.2 hours communicating with project stakeholders, and 7 hours organizing the job site and people.

Time spent on non-optimal activities included 5.5 hours looking for project data, 4.7 hours on conflict resolution, and 3.9 hours dealing with mistakes and rework. Thirty-five percent of their time (14.1 hours per week) were wasted on non-productive activities.

Furthermore, respondents from the U.S. claimed that poor project data and miscommunication on projects were responsible for 48% of all rework, accounting for a total of $31.3 billion in rework in the U.S. alone in 2018. The remaining 52% of rework was caused by other factors including design changes or issues, faulty or delayed materials, unforeseen conditions, and other issues.

Poor communication represents an annual cost of $17 billion to the U.S. construction industry and poor project data represents $14.3 billion.

Some of the key findings of the study are:

- Construction workers lose almost two full working days each week solving avoidable issues and searching for project information.
- Almost half of all rework is due to poor communication among project stakeholders, and poor project information.
- Workers are not taking full advantage of mobile devices and IT investments.
- Technology is expected to improve data management and increase productivity.

Construction companies are looking for ways to positively impact productivity and ultimately their bottom line. While it's obvious that improvements to the IT infrastructure at these companies would enhance productivity, *people* make technology work.

The study found that technology investments were made to provide better access to data (58%) and improve productivity (57%). However, weak end-user adoption was cited as an issue. Although 75% of the companies surveyed give project managers and field superintendents mobile devices, only 18% of the firms reported consistently using mobile apps to access project data and collaboration. Instead, the devices are used for sending emails and text messages or making phone calls.

The most common reason cited for spending more time than expected on a task was poor communication among project stakeholders

(23%). Most respondents stated that more time is invested in certain activities because of having inaccurate project data or difficulty accessing the information they need. The two most common causes of poor communication were unresponsiveness to questions and requests (31%), followed by the inability of project stakeholders to collaborate effectively (24%).

It may be more important for contractors to invest in their workforce. Maybe it's time to address why poor communication is causing days in lost productivity.

According to a Gallup research study entitled "The State of the American Workforce 2018," of the approximately 100 million people in America who hold full-time jobs:

- 30 million (30%) are engaged and inspired at work, having exceptional managers,
- 20 million (20%) are actively disengaged, having managers that make them miserable, and
- 50 million (50%) are not engaged, present or are uninspired by their managers.

Gallup estimates that active disengagement costs the U.S. $450 billion to $550 billion per year.

Managers who focus on their employees' strengths can practically eliminate active disengagement and double the average number of U.S. workers who are engaged nationwide. Employee engagement is likely to improve in companies that:

- Hire people that are in alignment with the company's vision and purpose.
- Engage employees by acknowledging the importance of their contributions to achieving the company's goals.
- Develop employee strengths by focusing on their innate talents instead of forcing employees to do work that does not allow them to use their talents.
- Enhance employee well-being.

Managers should consider coaching their team instead of taking a command and control attitude. Employees want to know that management appreciates and values them. Employees also want to know that management genuinely cares about them as a person.

Gallup claims that companies that invest in their employees' greatest talents to optimize their performance are generally more profitable than those that do not. Furthermore, Gallup found that organizations that create a culture of well-being in their workplaces help employees become more engaged and thrive. Investing in employee selection, strengths, and well-being, as well as engagement initiatives, have the power to produce amazing results.

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Are You Ready for the Golden Years? Most Americans Are Not

By David Gibbs, CPA, CCIFP, MBA

The age of working for one company for your entire career to receive a generous pension plan is over. Instead, 80% of Americans now work at companies that offer a 401(k) or a similar retirement plan. Typically, an employee invests a percentage of their income and employers "match" a portion of the employee's investment.

According to Fidelity Investments, the average 401(k) balance increased to $104,300 last quarter, up 13% from one year ago. The average IRA account balance similarly soared, climbing 13% to $106,000.

Even with these results, research from the U.S. Census Bureau discovered that only 41% of employees contribute to their retirement plans.

The Average American Simply Has Not Saved Enough Money

The Employee Benefit Research Institute claims that only six out of every 10 workers are saving for retirement. One in 10 workers have a formal plan to ensure financial security in retirement. The median American worker estimates they'll need to save $1,000,000 for a comfortable retirement. Even so, only 15% of Americans believe that their current savings habits are going to provide them with an adequate nest egg.

The bottom line is that most Americans are not financially ready for retirement. The Economic Policy Institute's 2016 report claims that the median retirement savings for families aged 56-61 is $17,000. For households between 50 and 55, the median retirement account balance is a mere $8,000.

Max Out on Your Contributions

Fidelity found that only 30% of 401(k) savers increased the amount they're contributing to their retirement plans in 2017. According to Fidelity, the typical worker is contributing 8.6% of his or her income to a 401(k) plan. However, it will take saving 10% to 15% of your income for most people to cover their monthly expenses. If contributing more to your plan seems impossible, increase your rate in small increments annually until you get a satisfactory level.

It is advisable to contribute the maximum amount allowed by the IRS in your 401(k) plan or IRA. The contribution limit was $18,500 in 2018 and will increase to $19,000 in 2019. If you are age 50 or over, the catch-up contribution limit is $6,000 for 2018 and 2019. Employer match or profit-sharing contributions aren't included in these limits.

According to Fidelity, maxing out your 401(k) for 10 years will provide you with a decent amount of money to retire on, even with a somewhat conservative 6% average annual return on investment.

Living on Your Retirement Savings

One rule of thumb is that you should be able to withdraw 4% of your retirement savings each year (adjusted for cost-of-living increases). The average person in their 60s will generally be able to withdraw only $6,880 in annual income from their savings and collect less than $17,000 in Social Security. That brings their annual income to $23,880.

According to the Bureau of Labor Statistics, the average household spends more than $40,000 per year in retirement. That number will increase substantially if you have health issues.

Set Goals and Be Strategic

People who have clear goals and a strategy have generally made more progress saving for retirement. It is important to establish a savings and spending budget. Consistently pay yourself first. Live within or under your means. Pay off your debt as soon as possible

and avoid using credit cards unless you can pay the balance in full when it is due.

Meet with a financial planner who can help you decide on your investment strategy. Be conservative in some areas and aggressive in others. Keep a watchful eye on your investments to ensure you are making money but avoid jumping to quickly to make changes due to fluctuations in the market. This is a long-term investment. Depending on the situation, it might be better to stay put.

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Meet Don Kaiser, CPA

By Rich Higgins, CPA

Don Kaiser, CPA

"Motivation is the art of getting people to do what you want them to do because they want to do it."

- Don's favorite quote by Dwight D. Eisenhower

As an Eagle Scout, Don Kaiser, CPA and principal, brings the core values of being trustworthy, loyal, and helpful to every client engagement. Don has lived his life knowing that he can make a real difference by holding true to his innate belief that everyone needs someone they can count on in a time of need.

He provides accounting, audit, tax, and IT consulting services to the firm's diversified base of medium-to-large corporate clients. Don makes it a point to thoroughly know his clients' business and industry so he can make recommendations that are in alignment with their goals. Although Don specializes in working with clients in the construction and retail industries, he keeps abreast of global and national business trends that could impact any of the firm's clients.

Clients know that they can depend on Don to be there for them and deliver beyond their expectations. Whether it is a question on a new accounting pronouncement, change to the tax law, or an issue with their accounting system, Don is there to explain the answer.

Don is passionate about helping his clients succeed. His work goes beyond what is provided by the typical accountant. Don is always looking for innovative ways to improve operations and enhance profitability. He has helped clients obtain bank financing to make capital investments, expand bonding facilities to invest in new projects, and maintain financial reporting systems when life events require key employees to be with their families.

A wizard in information technology, Don works with clients to establish the necessary reporting systems to produce meaningful reports on the financial health of their business. He is also instrumental in bringing state-of-the art technology to the firm.

Don graduated from William Paterson University in 1993 with a Bachelor of Science degree in accounting. He joined the firm in 1997 and was named principal in 2016.

Don is a member of the New Jersey Society of Certified Public Accountants (NJCPA), American Institute of Certified Public Accountants (AICPA), Construction Financial Management Association (CFMA), Utility Transportation Contractors Association (UTCA), and National Association of Surety Bond Professionals (NASBP). Don is also a member of the Benevolent and Protective Order of the Elks and serves on several committees at his church.

Married and the father of two children ages 17 and 20, Don is passionate about inspiring youth to achieve their personal best. He has served as a scoutmaster of a Boy Scout troop and a youth girls soccer coach for the past 12 years.

Although Don did not go to Notre Dame, another one of his favorite quotes is: "Play like a champion today." Don is known to work hard and play hard. Don enjoys all kinds of sports including golf, biking, hunting, fishing, skiing, and swimming. An avid camper, Don likes hiking and reading by the campfire, as well as connecting with nature. His other hobbies include woodworking and model railroading.

I have worked closely with Don since March 1997. I am impressed with his motivation, knowledge of accounting, and loyalty. I consider Don a valued business associate and friend.

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Don with his family

About the Author

Rich Higgins, CPA

Richard Higgins, CPA, is a principal with McCarthy & Company, PC. Contractors trust Rich to assist them with a strategy to achieve their goals. He helps contractors to establish realistic benchmarks to assess how well they are doing or to alert them to issues that need to be addressed. By looking at key indicators such as productivity, job costing, profit margins and cash flow, Rich helps clients to reach or exceed their goals. Because of the high level of attention Rich pays to his clients and their businesses, he is considered a trusted advisor and solution provider.

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