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HOW TAX REFORM WILL IMPACT CONSTRUCTION

By Maureen McGetrick

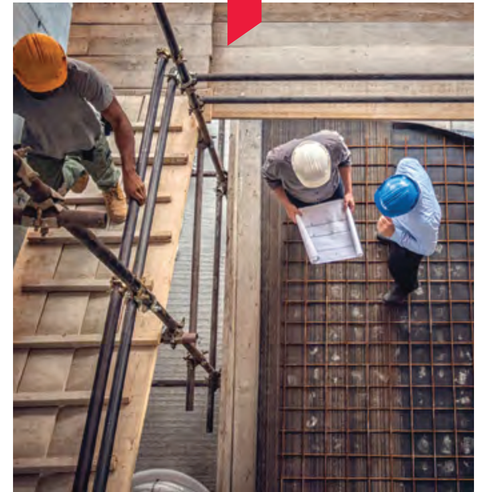
Every type of industry is impacted by the passing of the bill known as the Tax Cuts and Jobs Act (TCJA), and the construction industry was not left out of the party.

However, the precise impact will depend upon the structure of the business and the nature of its operations. For construction businesses organized as C corporations, the most significant changes are the reduction in the corporate tax rate, the 100-percent bonus depreciation deduction, the elimination of the corporate AMT, modifications of rules for use of certain accounting methods, and the limitations on interest expense deductions. A number of these items also impact construction companies organized as pass-through entities, either S corporations or Limited Liability Corporations taxed as partnerships (including General Partnerships, Limited Partnerships or Limited Liability Partnerships), but there are also considerations specific to flow-through structures, including the applicability of the deduction for qualified business income, also referred to as the Section 199A deduction. This article focuses on a high-level discussion of the important considerations construction companies should focus on in the wake of tax reform.

CHOICE OF ENTITY

Given the wide sweeping changes to both the corporate and individual tax systems brought on by the TCJA, it's an opportune time for construction businesses to reconsider the tax structure chosen for the business, especially since construction businesses tend to be closely held and therefore organized as flow-through entities. This can be a complex analysis, and would largely be driven by determining the net effective rate as a C corporation versus the rate as a pass-through entity, which will be influenced by many factors including:

- The state(s) in which the corporation does business (i.e. state effective rate);
- Whether the owners materially participate in the business;
- The level of compensation paid or required to be paid to any owners who provide services to the business to ensure reasonable amount of compensation;



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- Whether the entity makes distributions or profits regularly, or whether it would prefer to accumulate profits to grow the business;
- Whether there is a planned exit from the business in the near future;
- Whether the business has any international operations; and
- Whether the business would be eligible for the 199A deduction (discussed below in more detail).

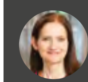
Other factors should be considered in the choice of entity analysis as well, including legal implications and the associated compliance costs of each structure.

199A DEDUCTION

The TCJA provides a 20-percent deduction for pass-through entities which generate "qualified business income," subject to certain limitations. Qualified business income is generally active income from a qualified trade or business (this definition generally excludes investment income as well as any income for personal services provided by an owner or shareholder). A qualified trade or business is typically defined as any trade or business other than a specified service business which includes the following industries: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investment management, and brokerage services. There is also a broad category included in the definition of trade or business that applies to any business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. Architecture and engineering were specifically excluded from the qualified trade or business definition. There is much uncertainty around these definitions, and the practitioner community has requested guidance from the IRS and Treasury on these items quickly given that these changes will apply for 2018.

While most construction businesses might seem to fall within the definition of a qualified trade or business, it is uncertain how the law will be interpreted at this point. Assuming that you get over the hurdle for a qualified trade or business, the deduction for qualified business income will be limited to the greater of either: 1) 50 percent of W-2 wages with respect to the trade or business, or 2) 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis of qualified property. Qualified business property would generally include assets held at the end of the year, used in the trade or business during the year, and for which the depreciable period has not ended. The depreciable period is the later of 10 years from the original placed in service date or the last day of the last full year in the recovery period under Section 168.

Assuming a construction business is eligible for the 199A deduction, it could reduce the top federal rate on business income from 37 to 29.6 percent, therefore making a pass-through structure an attractive alternative. However, companies must first evaluate the many planning considerations as summarized above to understand the full impact of tax reform on their business.



Maureen McGetrick is a partner in BDO's Corporate Tax Consulting practice. She can be reached at mmcgetrick@bdo.com or 212-885-8391.

HOW DO I GET MORE INFORMATION?

STUART EISENBERG
Real Estate and Construction Practice Leader
212-885-8431 / seisenberg@bdo.com

IAN SHAPIRO
Real Estate and Construction Practice Co-Leader
305-420-8052 / ishapiro@bdo.com

JUSTIN AMICO
Assurance Partner, Boston
617-456-2451 / jamico@bdo.com

BRIAN BADER
Assurance Partner, New York
212-885-8203 / bbader@bdo.com

JEFF BILSKY
Tax Partner, Atlanta
404-979-7193 / jbilsky@bdo.com

RICHARD HANSON
Tax Partner, Chicago
312-863-2310 / rhanson@bdo.com

BRENT HORAK
Assurance Partner, Dallas
214-665-0661 / lhorak@bdo.com

EDWARD PLUNKETT
Assurance Partner, Greater Washington, D.C.
703-770-6353 / eplunkett@bdo.com

CARRIE SHAGAT
Assurance Partner, Orange County
714-668-7328 / cshagat@bdo.com

TANYA THOMAS
Managing Director, Greater Washington, D.C.
703-336-1464 / tthomas@bdo.com