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CONSTRUCTION INDUSTRY ADVISOR

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Risk management

Could a captive insurance company suit you?

Insurance is a challenge for most construction businesses. You want to control your costs, but you may struggle to obtain affordable coverage of difficult-to-insure risks or fill "gaps" in your existing coverage.

One potential solution for fast-growing or well-established construction businesses is captive insurance. It can help reduce premium costs while providing a variety of valuable financial and tax benefits. It's also an ambitious move fraught with certain risks, so you'll need to understand the concept fully before deciding whether to move forward.

Various structures

Simply put, a captive insurance company is an insurer established to provide coverage to the company or companies that own and control it. There are many ways to structure one of these companies, including as a:

- Single-parent captive, which is a wholly owned subsidiary that insures only the parent company and its affiliates,
- Group captive, which is formed by, and designed to provide coverage to, members of a group (such as several related companies with a common parent or members of an industry or trade association),
- Rent-a-captive, whereby a sponsor furnishes capital for the captive, which then covers participating companies for a fee (customers essentially "rent" access to the capital), and
- Cell captive, which is like a group captive, except that members' assets and liabilities are segregated into "cells" that insulate them against losses suffered by other members.

The right structure for an insured or group of insureds depends on several factors, including their insurance needs and resources.

Potential benefits

Captives offer many potential benefits, such as:

Reduced costs. Captives usually offer lower, more stable premiums than commercial insurance

Big tax breaks for microcaptives

Captive insurance companies enjoy significant tax benefits. (See main article.) But "microcaptives" have an additional advantage in that they can exclude premium payments from their taxable income and pay taxes only on their net investment income.

To qualify as a microcaptive, a captive's annual premiums must be within a specified inflation-adjusted limit (currently, $2.3 million). And it must meet certain other requirements, including a diversification requirement. There are two ways to satisfy this requirement:

1. Ensure no single insured party is responsible for more than 20% of the captive's premiums, or
2. Structure the captive's ownership so it roughly mirrors ownership of the party or parties it insures (within a 2% margin).

It may be possible to establish several microcaptives with different owners to stay within the premium limit. But keep in mind that the IRS generally views microcaptives as potential tax avoidance devices, so it's important to structure them carefully to avoid a challenge.

companies, in part because commercial prices include a significant markup to cover the insurer's expenses and profits. Plus, captives give their owners direct access to wholesale reinsurance markets for protection against catastrophic losses.

Customized coverage. Because the insured parties control the captive, they can tailor coverage to meet their specific needs and may enjoy broader coverage and higher limits than they can readily obtain from conventional insurance carriers.

Claims control. Because the captive handles claims, insured parties have greater control over the claims review process.

Potential investment income. A captive's owners participate in the company's underwriting profits and investment income. In other words, to the extent premiums paid to the captive exceed losses, the company has a surplus that can be used to generate investment income for its owners.

Tax impact

Captive insurance is a form of self-insurance. But unlike ordinary self-insurance reserves, premiums paid to a captive insurer are generally tax-deductible as a business expense (like premiums paid to a commercial carrier) provided the captive qualifies as an "insurance arrangement" for federal tax purposes.

To determine whether an arrangement qualifies, the IRS focuses on two factors: First, the insured parties must shift risk to the captive. Typically, that's not a difficult hurdle to clear, since risk-shifting is the purpose of most captives.

Second, there must be risk distribution — that is, a captive must spread risk among enough independent insured parties to minimize the chances that a catastrophic loss will wipe out its reserves. Whether risk distribution exists depends on an arrangement's facts and circumstances, but the IRS has offered some guidance.

For example, the agency has ruled that a wholly owned captive that insures only its parent's risks doesn't distribute risk, but one that receives 50% of its premiums from parties unrelated to the parent does distribute risk. A single-parent captive may also distribute risk by participating in a "risk distribution pool" with other captives.

If a captive qualifies as an insurance arrangement, the reserves it sets aside to pay claims are tax-deductible, allowing the funds to be invested and grown on a tax-deferred basis. Eventually, excess reserves can be paid out to the owners as dividends taxed at long-term capital gains rates — essentially converting ordinary income into capital gain. Even greater tax benefits are available to "microcaptives." (See "Big tax breaks for microcaptives" on page 2.)

Pros and cons

As mentioned, creating a captive insurer is far from risk-free. You are, after all, literally launching your own insurance company. Doing so will require substantial up-front capital, after which you'll face administrative costs, compliance obligations and a keen need to develop insurance-related expertise. But for construction companies ready and willing to take the plunge, the concept could provide some remarkable benefits if all goes well. ■

Final pass-through deduction regs offer welcome guidance

In January, the IRS issued final regulations under Internal Revenue Code Section 199A. This section allows owners of pass-through entities — sole proprietorships, partnerships, limited liability companies and S corporations — to deduct up to 20% of their qualified business income (QBI) from those entities.

Owners of construction companies organized under these entity types should take a close look at the regs in consultation with their CPAs. Their eligibility for the deduction may have changed or there might now be more opportunities for maximizing this potentially valuable tax break.

A tale of two limits

The deduction is subject to two significant limitations for owners whose taxable income exceeds certain thresholds. First, it's unavailable for specified service trades or businesses (SSTBs), including consultants. Second, the deduction is limited to 50% of the owner's allocable share of the entity's W-2 wages or, if greater, 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified depreciable property.

Both limitations are phased in gradually, beginning at taxable income of $157,500 ($315,000 for joint filers). They're fully applicable when taxable income reaches $207,500 ($415,000 for joint filers).

Highlights for contractors

For the most part, the final regulations conform to proposed regulations issued in August 2018, with a few important modifications. Although the final regs generally apply to tax years ending after February 8, 2019, taxpayers may rely on either the final or proposed regulations for tax years ending in calendar year 2018. Here are some highlights for construction companies:

Independent contractor vs. employee. Sec. 199A specifically excludes "performing services as an employee" from the trades and businesses eligible for the QBI deduction, so there may be an incentive for construction workers to convert from employee to independent contractor status to qualify for the deduction.

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The proposed regulations put a damper on this strategy by providing that an employee who's subsequently treated as a nonemployee while performing substantially the same services is presumed to be an employee for Sec. 199A purposes. The final regulations take this a step further, providing that the presumption will continue for

three years after the conversion. The presumption can be rebutted with evidence that the worker is performing services as an independent contractor.

Consulting services. Construction businesses may provide certain consulting services connected with the performance of construction services without being considered SSTBs (provided they're not paid for separately). But certain standalone consulting services may jeopardize the pass-through deduction for high-income owners. Fortunately, the regulations contain a "de minimis" rule: A business is not an SSTB if less than 10% of its gross receipts (5% if gross receipts exceed $25 million) is attributable to consulting or other specified services.

What if a construction company's standalone consulting services exceed the de minimis threshold? Under the proposed regulations, that would have tainted all the business's income, making its high-income owners ineligible for the pass-through deduction. The final regulations, however, allow owners to claim the deduction for QBI attributable to non-SSTB services if the firm's SSTB and non-SSTB trades or businesses are "separate and distinct." What defines "separate and distinct" is a factual question. But, at minimum, the company must keep a "complete and separable set of books and records" for each trade or business. An example in the final regulations suggests that it's helpful if each trade or business has separate employees, though it's unclear whether that's a requirement.

Aggregation. To maximize the deduction, the proposed regulations allow owners to aggregate separate businesses for Sec. 199A purposes, provided they're part of a larger, integrated trade or business and meet certain other requirements. The final regs contain several provisions that make aggregation easier, including an option to make an aggregation election at the entity level.

A complex deduction

The Sec. 199A deduction is complex. The final regulations and accompanying commentary are well over 200 pages. Again, if you own a pass-through entity, you should consult your CPAs to determine eligibility, calculate the amount of the deduction and identify strategies for maximizing it. ■

Checking your paperwork for slow cash flow contributors

Most contractors struggle with cash flow occasionally, if not regularly. These problems can take a variety of shapes and sizes and stem from many causes. One common contributor to cash flow slowdowns is the very paperwork you use to arrange and close out projects: namely, your contracts and invoices.

Read the fine print

When you think about money problems, your mind might immediately go to the end of the construction process when you're trying to get paid. But the seeds of monetary discontent are often sown before a shovel hits the dirt. Case in point: the contract's payment terms.

In the broadest terms, contractors have two basic options. You can either get payments that are received upon completion of specific job phases, or be paid by an owner in equal installments over the course of the project.

If you've been accepting one or the other without question, consider the negative impact on your

cash flow. Receiving payments on completion puts you at the mercy of the many random events that can delay a project. Meanwhile, the installment approach may leave you underfunded at key moments. You might try renegotiating the payment terms.

Familiarize yourself with each owner and scale your invoicing procedures to suit the situation.

Also review a contract's payment terms in light of the owner. Does the language seem equitable given the person's or company's financial strength and creditworthiness? Don't stop there, either — assess the capacities of suppliers and vendors as well. And, as a job gets underway, try to establish a good working relationship with the owner's accounts payable representative to ensure the payment terms will be followed.

Know thy customer

Of course, it's indisputable that cash flow issues often originate with owners. Whether people or companies, project owners will typically delay payment as long as possible to benefit their own cash flows. Meanwhile, your unpaid invoices may pile up and your cash flow drags.

One general rule of thumb says that contractors must live with getting paid within 60 to 90 days. But, to boost cash flow, set a company objective to whittle that down to 50 days or even less. The nuts and bolts of precisely how to do so will vary, depending on the type of construction work you do and the structure of your contracts. But there are certain tried-and-true procedures that can help. Use an electronic billing system to invoice owners instantly. Revise your invoices so they clearly express terms, amounts and consequences for tardy payments.

Moreover, abide by that old expression: Know thy customer. Familiarize yourself with each owner and scale your invoicing procedures to suit the situation. With some owners, a clear invoice alone will do the trick. But others may need a call for a more hands-on approach. This is particularly true when dealing with an owner that has given you payment problems in the past. In these cases, make an extra effort to invoice the customer on time and be prepared to follow up diligently.

Sign here

No one loves doing paperwork, but these two types of documents — the job contract and your invoices — can drive the success or failure of a project. So, be sure to cross your t's, dot your i's and know precisely what you're signing off on.

Watch out for joint employer rule

There's no getting around it: Construction is an inherently collaborative enterprise. Many, if not most, projects involve a variety of contributors. But therein lies a danger. Contractors who exercise control over the employees of subcontractors or other parties — or reserve the right to exercise such control — risk being ensnared by the so-called "joint employer rule."

State of flux

The consequences of being deemed a joint employer are serious. For example, one entity becomes bound by another entity's collective bargaining obligations and may be held jointly liable for any unfair labor practices another entity commits.

Unfortunately, the joint employer rule is in a state of flux. For many years, the National Labor Relations Board (NLRB) took the position that one entity wouldn't be considered a joint employer unless it exercised "direct and immediate" control over the essential terms and conditions of another entity's employees. Essential terms and conditions include activities such as hiring, firing, wages, discipline, supervision and direction.

But in a 2015 case — *Browning-Ferris Industries* — the NLRB expanded the joint employer rule to include entities that exercise indirect control over another entity's employees (though the meaning of "indirect control" is vague), or contractually reserve the right to control another entity's employees, even if such control is never exercised.

Proposed rule

In September 2018, the NLRB issued a proposed rule that would essentially overrule *Browning-Ferris*. Under the proposal, to be treated as a joint employer, an entity must "possess and actually exercise substantial direct and immediate control over the employees' essential terms and conditions

of employment in a manner that is not limited and routine."

But then, in December 2018, a federal appellate court upheld the NLRB's decision in *Browning-Ferris*. It's uncertain how this decision will affect the joint employer rule, though the NLRB chairman has said that the Board isn't compelled to adopt the court's position.

It may be some time before the NLRB finalizes its new joint employer rule. It's also possible that Congress will provide a legislative solution. In the meantime, it appears that *Browning-Ferris* stands as the leading authority on joint employment.

Procedures and contracts

If your construction company typically takes the lead on projects involving subcontractors or independent contractors, now's a good time to review your operational procedures. Specifically, you should limit any potential liability you might incur by avoiding the exercise of control over other parties' employees.

In addition, review (or ask your attorney to review) the contract documents typically used on your jobs. Of particular concern are any contractual reservations of authority to exercise control over the employees of other entities. ■

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Contractors: Are You Ready to Implement the New Lease Standard?

In early 2016, the Financial Accounting Standards Board (FASB), the body that sets accounting principles for U.S. entities, released a new accounting standard on how businesses should account for their leases. Accounting Standards Update 2016-02, *Leases* (Topic 842), is effective for public entities for fiscal years beginning after December 15, 2018, and non-public entities must be ready to implement it for fiscal years beginning after December 15, 2019. As you begin reporting under these new standards, there are a few key things you need to remember.

The treatment of capital leases (renamed "finance leases") has generally stayed the same as prior guidance under Generally Accepted Accounting Principles (GAAP). These leases are recorded on the balance sheet as an asset and as an offsetting liability for the value of the remaining lease payments. Under prior guidance, an operating lease was recorded on the income statement as "lease expense" and left off the balance sheet all together. However, under the new accounting standard, operating leases will be recorded on the balance sheet as (1) a "right of use" asset to represent the company's right to use the asset for the lease term, and (2) an accompanying liability for the present value of the remaining lease payments. The only leases that can remain off the balance sheet all together are leases less than 12 months in duration and there cannot be an implied obligation or expectation to renew the lease at the end of the period.

As you begin to implement these new rules, you may find that you need new or different software to help you. Not only will you need to calculate the value of your lease payments, but you will also need to collect information that you can use to fulfill the quantitative and qualitative disclosure requirements of Topic 842. Therefore, choose a software that will support your internal controls, work with your volume of leases, have adequate reporting functions, and keep a depreciation schedule for both federal and state purposes.

As contractors, your bankers or bonding agents expect you to maintain certain financial ratios. Since your balance sheet will look different going forward, the new lease standard may put you at risk of not satisfying certain financial covenants or not meeting required financial ratios. Return on assets (ROA), for example, shows the percentage of profit you earn ("net income") in relation to your resources ("total assets"). When your assets increase as a result of this new lease standard, your ROA ratio will decrease. If your bank requires a certain ROA to continue financing your projects, you may need to modify covenants in your existing debt agreement or find a new bank.

Quite often, contractors lease high-value equipment to use on their projects, so this accounting standard change is likely to affect contractors more acutely than other entities. It is important to understand the impact of this new guidance on your financial statements and have a good team assisting you in the implementation process. Contact a member of the LaPorte Construction Industry Group if you need help implementing this new standard.