On-Site

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Real estate ownership

THE INS AND OUTS OF CAP RATE FOR CONTRACTORS

Many contractors build and build but never get to the easy part of construction: owning that well-built piece of property and collecting rent. Those that do try their hands at real estate ownership often get caught in the trap of buying residential rental properties and encountering troubled tenants who can't or won't pay their rents on time.

Commercial rental properties with established tenants and long-term leases (for 10 years or more) tend to be much more stable investments, so it pays to learn how to approach buying them. Let's look at how contractors can use capitalization (CAP) rates to establish commercial owner-lessor profitability for a purchasing decision.

An objective comparison

In most cases, you can determine the CAP rate of a commercial tenant lease property by taking the annual rent and dividing it by the purchase price of the building with the tenant in it. Knowing how to determine CAP rates is helpful because so many other variables exist that it can be daunting to even consider acquiring such properties.

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True to their name, commercial tenant lease properties are those in which the tenant doesn't live there. Stores, malls, warehouses and manufacturing plants are all commercial tenant lease properties. Apartment buildings, duplexes and rental homes are residential lease properties.

Using the CAP rate properly gives a contractor-buyer the chance to compare one property to another without becoming overly involved in what kind of tenant is occupying the building. This can be a confusing distraction. You can compare an auto store, pharmacy, private school or entertainment complex using the same metric — CAP rate — to make the commercial property purchasing decision a little easier.

NNN leases

Here's an example: a commercial building with a tenant currently paying $194,000 a year in rent hits the market (with the tenant in it) for $3.104 million. That would be a CAP rate of 6.25%, assuming the property is a triple net

HOW TO GET STARTED BUYING COMMERCIAL PROPERTIES

So, the notion of buying a commercial rental property with established tenants intrigues you but you're not sure how to get started. You could (and should) start slowly by consulting an experienced commercial real estate agent or attorney. In many locales, there are also real estate ownership groups that meet regularly to discuss topics such as tax law updates and innovative cash management or financing strategies.

If you already own multiple residential buildings, a good way to approach buying your first, say, $3 million to $4 million commercial tenant rental building is to "trade up." Doing so may be feasible through a like-kind exchange or similar arrangement, which should be carefully investigated with the help of your CPA and attorney. Sometimes the mortgages of "traded up" residential properties can be paid off under the new purchasing transaction, and the new property can be valued higher because of appreciation of the properties being relinquished.

lease. Otherwise, net operating income should be used instead of rent in the CAP rate calculation.

A triple net lease (also known as a "NNN lease") is one under which the owner isn't responsible for any costs of maintaining the building. The tenant must pay for anything that goes wrong and needs repair, as well as any costs of maintaining the inside or outside of the building to the perimeter of the property.

Under a triple net lease, the tenant is responsible for establishing and maintaining full schedules of capital repair and replacement costs and making sure building components are kept up and replaced when necessary — even though you own the building. Once you've bought a property with a triple net lease, you should incur zero out-of-pocket costs and have little need to communicate with the tenant.

This type of purchase is generally "turnkey" in that you invest the money and then simply collect rent. Chasing after a delinquent tenant or going to small claims court to collect or evict are relatively rare occurrences when the commercial lease tenant is a nationally known chain restaurant or well-established pharmacy and drug store franchise. However, check with your CPA regarding the tax implications of holding a rental property of this size and type.

Other terminology

There is such a thing as a double net lease. This is one in which the roof and structural components of the building are the owner's only required maintenance and repair costs. The tenant retains responsibility for all other maintenance and repair costs.

Under a double net lease, the tenant makes and maintains contracts with repair, maintenance and landscape vendors to maintain the property. In this case, it's a good idea for the property owner to retain 3% of the purchase price in a reserve or contingency account to provide for future repair or replacement costs of the roof and structural components.

Another common point of confusion among those deciding whether to buy a commercial lease property with a tenant is the lease type. A "fee simple" lease is one in which the owner owns both the land and the building. A "leasehold property" is one in which the land is owned but not the building. Be sure you're clear on all the terminology involved before signing on the dotted line.

Take it slow

If you're considering buying a commercial tenant lease property, don't rush into it blindly. Work closely with your professional advisors to formulate a feasible, financially sound approach to the purchase decision. ■

DO YOU NEED A REFRESHER ON THE LATEST DETAILS OF THE PPP?

It's been about a year since the Paycheck Protection Program (PPP) was launched under the CARES Act. For contractors, as well as other business owners, the PPP has been a double-edged sword.

On the one hand, it's provided much-needed financial relief during the COVID-19 pandemic. On the other, the complexities of applying for a loan and understanding the tax impact have been challenging.

With the passage of the Consolidated Appropriations Act (CAA) late last year, both edges of the sword got a little sharper. If the details of the CAA have faded a bit since the initial news, here's a refresher.

Loan forgiveness

As you may be aware, recipients of PPP loans may qualify for debt forgiveness if certain requirements are met and a timely application is submitted to lenders. The rules are complex. They include a stipulation that at least 60% of the borrowed funds must be used for payroll. Other expenses originally named eligible for forgiveness include rent, mortgage interest and utilities.

Under the CAA, four new expense categories now qualify:

1. Eligible operations expenditures. These include payments for software used for cloud computing, HR, payroll, sales/billing, and accounting for or tracking of supplies.

2. Eligible expenses for employee safety. These include some expenses incurred to buy personal protective equipment (PPE). Also applicable are expenses incurred to help the borrower comply with COVID-19 federal health and safety guidelines or equivalent state and local guidelines between January 1, 2020, and the end of the national COVID-19 emergency declaration.

3. Eligible expenses for property damage caused by civil unrest. These expenses cannot have been previously covered by insurance or other reimbursement. Construction companies that had job sites damaged during the past year may find this relevant.

4. Eligible supplier expenses. These include expenses paid for supplies that are essential to the entity for operations pursuant to a contract, order or purchase order.

Tax impact

The tax impact of PPP loans has been a matter of much confusion. Under the CAA, it's been clarified

that the IRS won't deny any deduction or tax basis increase for expenses paid with proceeds from forgiven PPP loans. In other words, if your construction business takes out a PPP loan that's forgiven, the forgiveness is a tax-free event for federal income tax purposes as the forgiveness income is not taxable.

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Furthermore, the CAA states that you can deduct expenses that were paid for with proceeds from forgiven PPP loans and you can obtain tax basis in assets that were paid for with proceeds from forgiven PPP loans. Generally, when the federal government allows tax-free treatment for a forgiven loan, you must reduce so-called tax attributes (net operating loss carryovers, capital loss carryovers and so forth). But under the CAA, no such reduction is required when PPP loans are forgiven. These favorable changes are retroactively effective to the first day of the PPP's launch.

Getting another loan

Are you interested in taking out another PPP loan for your construction company? If so, the CAA does allow eligible businesses to take out so-called "second-draw" PPP loans.

These loans are primarily intended for smaller and harder-hit businesses with 300 or fewer employees that have used up, or will soon use up, the full amount of their initial PPP loans. The maximum second-draw loan amount is $2 million, and only one such loan can be taken out.

In order to qualify for a second-draw loan, a company must demonstrate at least a 25% decline in gross receipts in any quarter of 2020 as compared to the corresponding quarter in 2019. Qualifying businesses can generally borrow up to 2.5 times their average monthly payroll costs for either the one-year period before the date on which the loan is made or calendar year 2019. The application deadline is March 31, 2021.

Finer points

The PPP has generally been helpful to construction businesses. If you're participating in any fashion this year, work closely with your CPA to manage the finer points. ■

MANAGING AN OFFSITE CONSTRUCTION PROJECT

Given the events in the past year related to COVID-19, "offsite construction" appears to hold more promise than ever for the building industry. As you're probably aware, under this model, major building components or even entire modular buildings are prefabricated offsite and transported to the job site for assembly.

From a public health perspective, reducing onsite labor leaves more space for other trades and onsite workers to social distance. Offsite prefabrication also requires fewer workers and is faster and more efficient than traditional construction methods. This helps lessen labor needs and reduce costs while shaving time from the project schedule.

However, managing an offsite construction job calls for both a higher level of coordination among

stakeholders and a seamless workflow from the front office to the fabrication facility to the jobsite.

Communication is a must

Offsite work demands early planning. All stakeholders — including the project owner, architect, engineers, general contractor, subcontractors and materials vendors — must be on the same page from the get-go. Doing so requires an integrated design and project delivery approach. Building and design disciplines must come together at the start of the job's lifecycle, and the entire team needs to be in place and engaged in planning before design starts.

Schedules also need to be developed and distributed as early as possible to facilitate just-in-time delivery of a modular building or prefabricated components that fit with absolute precision. After all, the cost of any rework needed during onsite assembly will cancel out the efficiencies gained through offsite prefabrication.

Technology drives the project

One critical way to enhance collaboration and project coordination — from predesign through completion — is to ditch paper processes in favor of digital tools that automate workflows and deliver real-time data.

Building information modeling (BIM) software is increasingly a perfect fit. It can be leveraged not only to design detailed, accurate 3D models and perform early clash detection, but also to sequence the design-to-fabrication workflow for building disciplines and communicate updates to project partners throughout the job. Like CAD systems, BIM models can be linked to "computer numerical controlled" machines used in the fabrication process via manufacturing software.

Also essential for offsite construction is using mobile technology to connect the project team to systems used as well as to other team members and colleagues onsite, in the office and at the fabrication facility. The construction phase requires ongoing planning and coordination as modular buildings or prefab components move through fabrication, shipping, and final assembly or connection at the jobsite.

What's more, as mentioned, project managers must manage logistics to ensure prefabricated components arrive just in time for assembly. One strategy is to assign assistant project managers or inspectors to offsite fabrication facilities to verify proper production of the components.

Preparation is key

Offsite construction seems to be trending toward "repetitious" projects in which standardization is desired, such as multifamily housing and health care facilities. However, it could be used to shorten schedules and more tightly control budgets on many other types of jobs. If your company decides to bid on an offsite construction project, be prepared to get involved early and to engage in a collaborative approach throughout. ■

6 HOT TRENDS IN CONSTRUCTION APPS

In the construction business, most of the day-to-day action takes place on the jobsite. Thanks to mobile technology, contractors can store vital project information on their smart phones and tablets for easy access and sharing on the go.

Keeping in mind that any technology purchase (even a free download) should be thoroughly researched and carefully considered, here are six of the hottest trends in construction apps right now:

1. Daily reports and punch lists. With a few taps of a finger, these apps let users take photos, make notes, assign tasks and generate professional reports from anywhere — including a jobsite. The reports can be shared via email or on cloud-based platforms such as Dropbox or Google Drive. (Examples: iNeoSyte and ArchiSnapper.)

2. Timesheet management. Time-tracking apps provide a way to record work hours without having to punch a physical time clock or fill out paper timesheets. Crews can log and track their time using the app or by simply entering a jobsite. (Examples: Hubstaff and ClockShark.)

3. Plans and drawings. Several apps allow users to easily view and manage construction plans and drawings. An architect or designer can publish drawings to a cloud server for easy sharing where you're then able to add notes, requests for information, punch lists and markups. You can even compare different revisions of documents or drawings by overlaying them. (Example: PlanGrid.)

Other apps let you create, access, share and print CAD drawings via a mobile device. You can leverage augmented reality to take measurements and create room plans in seconds. (Examples: FingerCAD and CamToPlan.)

4. Building information modeling (BIM). The latest BIM apps enable you to navigate multidimensional models and their associated data better than ever. Some facilitate production and resource planning, cloud-based field collaboration, and document sharing. (Examples: goBIM and Autodesk BIM 360.)

5. Touchless ticketing for deliveries. For several years now, concrete and other materials suppliers have provided customers with mobile apps to track and manage their orders. Some are now offering a paperless ticketing option that allows customers to electronically sign for deliveries via text or mobile app to ensure drivers and onsite construction workers are safely distanced. (Examples: ConcreteDirect and iStrada.)

6. Project management and jobsite coordination. For construction company owners who are looking to fully automate their jobs on one standard platform, there are apps that do it all. These solutions essentially combine all or some of the capabilities of the previously mentioned apps in an effort to manage projects, resources and financials from planning to closeout. (Examples: Procore, Bluebeam Revu and Fieldwire.) ■

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Worker Classifications — Where Are We Now, and Where Are We Headed?

When California passed its famed gig worker bill in 2019, businesses all over the nation took notice. This landmark bill required many businesses to convert contracted workers into statutory employees. And although this change only affected California-based companies, recent movement from the Biden administration suggests that a similar stance on employment classification may soon be applied at the Federal level.

California's Gig Worker Bill

In September 2019, California passed Assembly Bill 5 (AB5) that requires businesses to use a three-pronged test to prove that their workers are independent contractors. This three-pronged test — known as the ABC test — established a narrow definition of independent contractor and was purportedly designed to regulate companies like Uber and Doordash whose businesses relied almost exclusively on gig workers. In reality, AB5 affected many other industries that use contracted workers, like those in construction.

Federal Movement on Gig Worker Classification

Last year, the Department of Labor (DOL) published a final rule that established an "economic reality" test to determine a worker's classification. Because this test is subjective, many believe it helps preserve businesses' desires to keep contracted workers off the payroll. This test relies on two core factors:

(1) the nature and degree of the worker's control over the work; and

(2) the worker's opportunity for profit or loss based on their investment into their venture.

The DOL rule was set to go into effect on March 8, 2021, but it has since been postponed. On January 20, 2021, the Biden administration ordered that any rules published in the Federal Register that had not yet gone into effect would be postponed for at least 60 days until the policies could be reviewed by the new administration.

Future of Worker Classification

Only time will tell if President Biden approves or scraps the DOL final rule, but there is talk that the new administration could adopt stricter classification rules (like those in California) to broaden the employee base. At the time this story was written, the Biden administration has not yet released information in favor or against the DOL ruling. We expect to know more later this month.

Employee classification can heavily impact a business's operations and compliance costs. If more workers are considered employees, business leaders must allocate more money to pay for benefits like health insurance, paid time off, and worker's compensation, and they must spend more time preparing and filing state and Federal payroll tax forms.

However, the construction industry has always been adaptable, and some businesses may even benefit. For example, the Section 199A deduction, called the Qualified Business Income Deduction, is limited to a percentage of business's W-2 wages. Increasing W-2 wages may release some of this credit. Transitioning contracted workers into employees may also bring benefits that are less quantifiable, including having a more stable workforce, fixed and predicable payroll costs, and improved worker satisfaction.

For questions related to worker classification, contact LaPorte Tax Senior Manager Ross Robert at rrobert@laporte.com.