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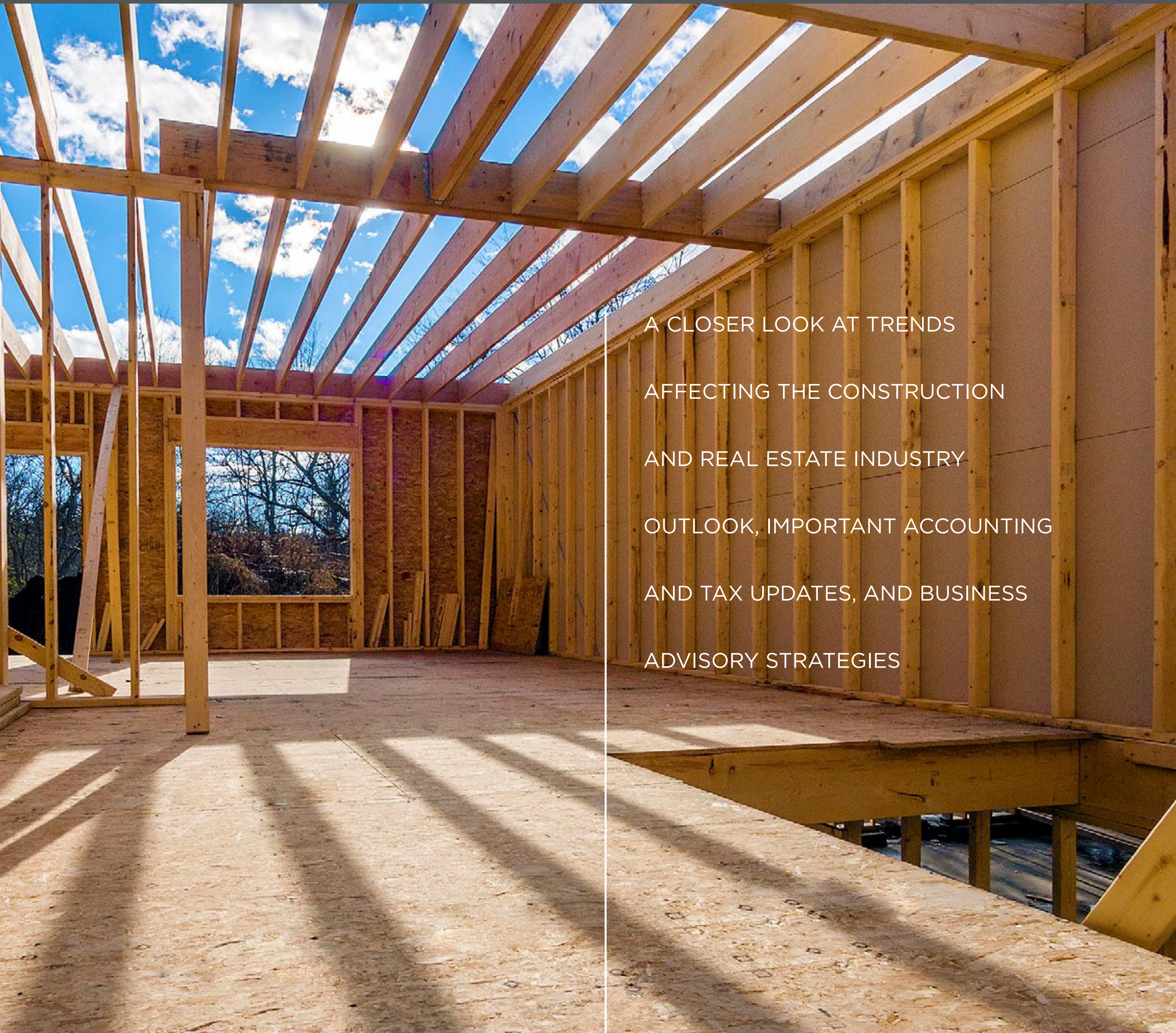
Construction & Real Estate
Trends, Updates, and Strategies



A CLOSER LOOK AT TRENDS AFFECTING THE CONSTRUCTION AND REAL ESTATE INDUSTRY OUTLOOK, IMPORTANT ACCOUNTING AND TAX UPDATES, AND BUSINESS ADVISORY STRATEGIES

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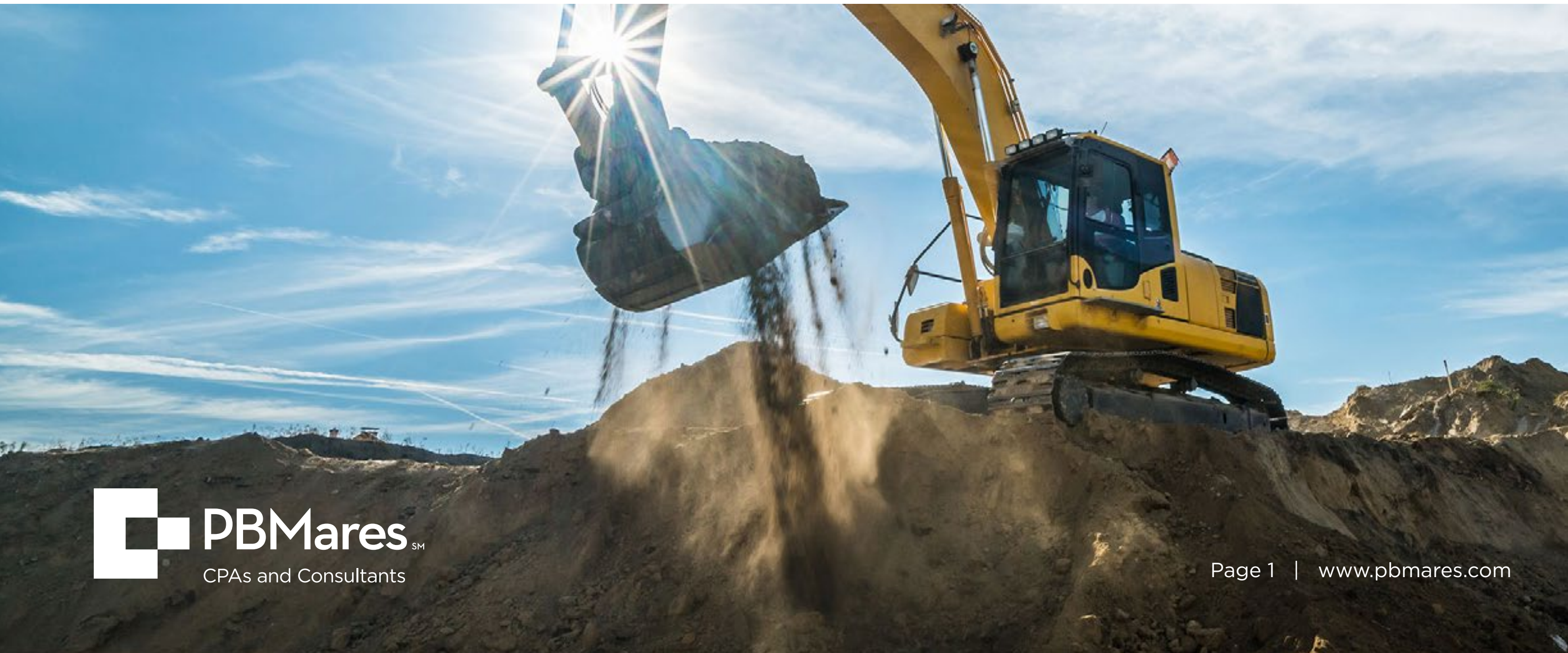


Introduction

Construction and real estate, industries that typically endure economic turbulence well, have weathered much since COVID. Large fluctuations in material prices, supply chain delays, worksite shutdowns and labor shortages, and rising interest rates are just a few of the headwinds that industry stakeholders have navigated since 2020.

Looking ahead, what can industry leaders expect? This whitepaper explores trends affecting the construction and real estate industry outlook, important accounting and tax updates, and different business advisory strategies to consider in the months ahead.

Industry Outlook and Midyear Trends

Real estate and construction were off to an interesting start in 2023.

Commercial real estate has been closely watched following the banking disruption, with uncertain market conditions keeping investors on their toes. Despite doomsday predictions around office space, there is cautious optimism the sector will prevail by focusing on quality and creative strategies. While luxury properties have enjoyed strong performance and investor favor, all hospitality segments are still challenged by inflation, a shortage of skilled labor, and consequently, diminished consumer experiences.

Real Estate Trends

Commercial real estate faces potential challenges

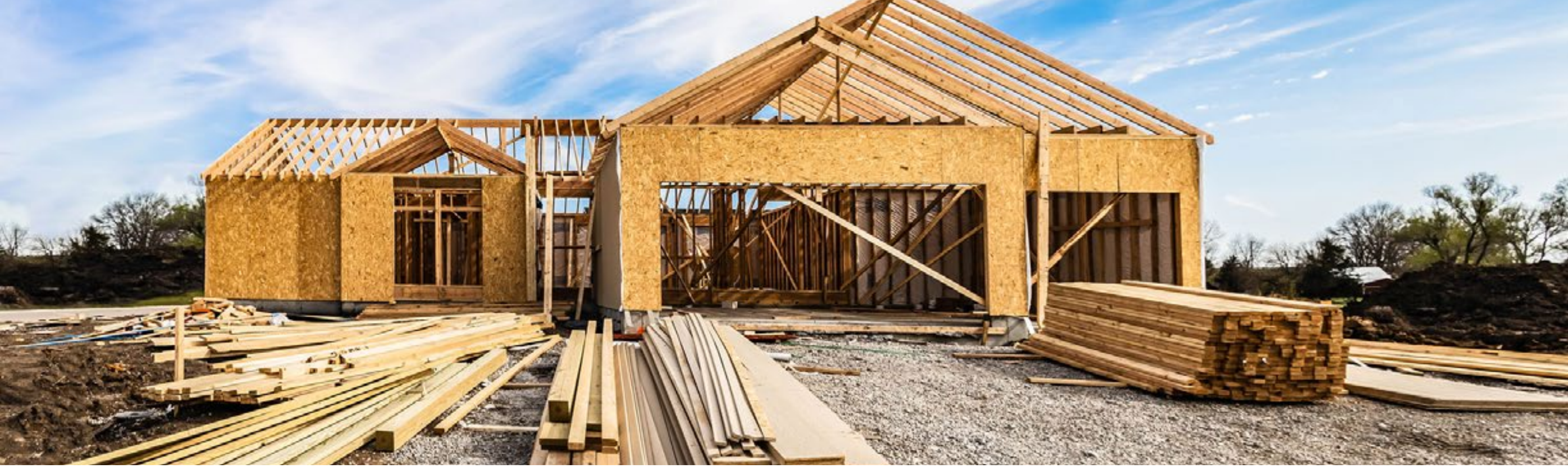
Office sector distress indicators have flooded the middle market, from public real estate investment trust (REIT) valuation impairments to high-profile loan defaults, signaling that a historically stable asset class is headed toward an unfamiliar new normal.

Pandemic-induced remote work arrangements have rapidly shifted from demand to oversupply. While some companies have implemented return-to-office mandates, the current workforce trend shows a steady increase in remote and hybrid work, leading to soaring vacancy levels in many metropolitan cities.

Shifting consumer preferences and a focus on luxury in the hospitality sector

The hospitality sector in particular is sensitive to current challenges in the broader economy: rising interest rates, higher inflation and a tight labor market. Even so, the industry is making strides post-pandemic as the focus shifts to high-end, experience-rich destinations in the luxury segment.

In the early days of the pandemic, coastal and resort hotels with lighter restrictions benefited from travelers escaping quarantine. Three years later, upscale properties are now leading a rebound, having enjoyed a renaissance built on steady room rates, distinctive accommodations and an affluent market that is less price sensitive in an inflationary economy. The luxury segment is expected to remain robust amid the broader economic slowdown.



Housing market affordability

After a drastic shift in the second half of 2022, the housing market started with a strong foothold in 2023 once builder sentiment rose following reports of an early spring selling season and stronger-than-expected sales.

The recent rise in mortgage rates caused many to rethink their buying decisions and created housing affordability issues across the United States. Affordability is now recognized as the primary hurdle in a housing market rebound despite recent overall strong performance in new home sales.

National home prices have spiked more than 40 percent since the pandemic. Home prices aren't expected to go down until mortgage rates do[i].

Until mortgage rates reach a more stable terminal rate, the near-term demand for housing will remain uncertain. Meanwhile, a confluence of factors are shaping a favorable long-term prediction for residential construction.

Construction Trends

Construction contractor confidence has been mixed. As of this writing, despite the backlog indicator holding steady at 8.9 months, contractor confidence fell to about the same point as one year ago. Most contractors aren't expecting a big change in profit margin or sales in the next six months[ii].

Interest rates continue to challenge construction growth

High interest rates and inflation continue to be top concerns for contractors.

Interest rates tend to trickle down throughout the economy 12 to 18 months after rates start rising. That means that throughout the end of summer and into fall are when contractors can expect to see more of an impact from rising rates, since the first rate increase was in March 2022.

A tangible impact of higher rates is higher borrowing costs. This is an issue that will keep going for several months and can potentially affect project viability. Contractors will need to ensure they have access to capital should they need it and keep the focus on maintaining positive cash flow.

Cost volatility is usually due to one of three factors, or a combination. They are:

- Transportation costs, including fuel, driver wages, and insurance
- Labor and materials costs
- International tariffs

Materials costs

Construction input prices are almost 40 percent higher now than in early 2020, though costs are down about 2.5 percent from last summer. The worst might be over, but costs are still rising in a handful of commodity categories, like concrete, prepared asphalt, and plumbing fixtures and fittings. Some experts believe that higher materials prices are here to stay[iii]. Still, contractors will need to maintain a diverse supply chain to stay competitive and get the materials they need.

The rise of green and 3D building

Cost-effective, quicker construction methods like prefabricated and modular buildings are a practical alternative to higher costs and material constraints. Depending on the project, prefab or modular construction – especially when paired with 3D printing – can speed up timelines and lower costs and waste.

Outside of prefab, modular, or 3D printing, sustainable building isn't so much of a trend as it is the future of construction. Contractors who incorporate eco-friendly materials and building practices will see benefits in higher value projects, lower costs for tenants, reduced waste, and an easier time complying with stricter building codes.

There are also tax incentives for green building efforts, like the 45L residential energy efficiency credit and the 179D commercial building deduction. New in 2023, 179D also applies to building retrofits, which could be another opportunity to pursue.

Labor challenges persist

There are approximately 25 percent more vacant construction jobs than people to fill them, according to one estimate. Most workers who left their jobs in COVID returned, but some left

the industry altogether. A continued shortage of skilled workers and looming retirements for workers age 55+ are other contributing factors. The construction industry will need to add more than 342,000 new workers to payroll in 2024 – in addition to normal hiring.

Many contractors have raised wages and increased benefits to attract and retain quality workers.

One way that contractors have been addressing the labor shortage nationwide is by recruiting women. In 2020, women in construction made up 11 percent of the workforce. That number has grown to about 14 percent. Partly because pay parity is significantly less in construction than in other sectors, many women have found an inclusive, non-traditional career path on the job site and in the back office.

Working with apprenticeship programs is another option, especially since many projects now require a certain amount of apprenticeship hours to help meet the threshold for different incentives[iv].

And with the availability of federal funding for **infrastructure** and sustainable construction projects, public projects can remain a steady source of revenue.

Accounting and Tax Updates

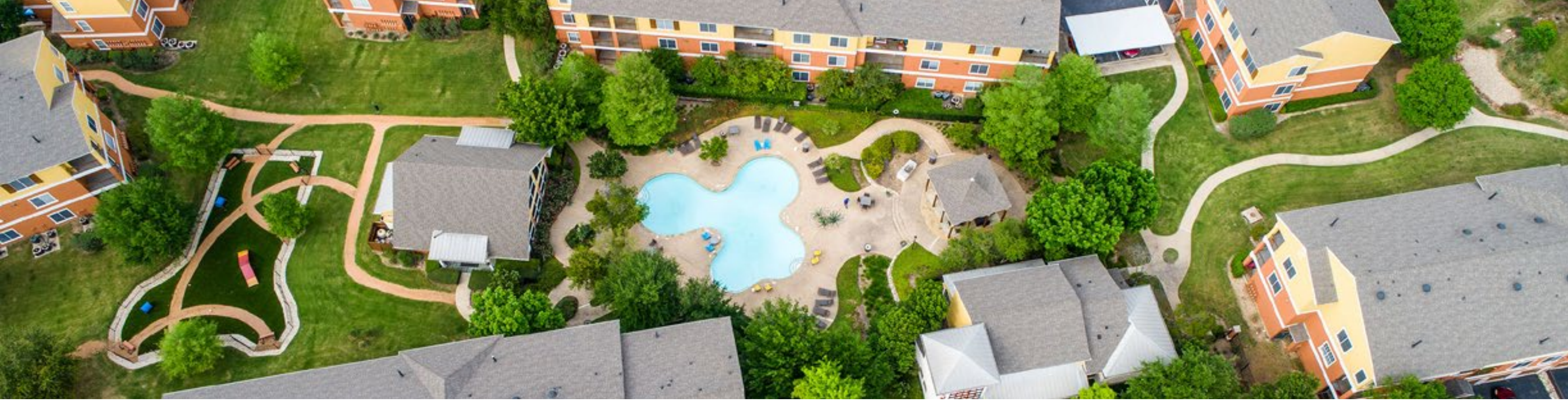
Construction contractors and real estate investors and owners have several new or expanded tax breaks at their disposal. From tax incentives for energy efficient buildings to accounting processes and other credits and deductions, it pays to be aware of what's available and how to qualify.

Alternative Cost Accounting

Real estate developers with multiple units may want to consider a new streamlined process for capturing the estimated costs of common improvements in the units' tax basis. **New IRS guidance for alternative cost accounting took effect on January 1, 2023.** The guidance defines when to use alternative cost accounting and how to allocate estimated costs for common improvements.

To elect alternative cost accounting for all qualified projects, real estate developers can now use a shortened *Form 3115, Application for Change in Accounting Method.*

Developers must use an overall accrual method of accounting and be contractually obligated to provide common improvements to a qualifying project. Common improvements are defined as "any real property or improvements to real property that benefit two or more units that are separately held for sale by a developer." In addition to contractual obligations to make the improvements, developers cannot also reclaim such costs through depreciation.



According to the Revenue Procedure, **examples of common improvements** are:

- Streets
- Sidewalks
- Sewer lines
- Playgrounds
- Clubhouses
- Tennis courts
- Swimming pools

Common improvement costs do not include property maintenance or repair costs, construction period interest, or property taxes.

Previous guidance required developers to submit paperwork for each project in their portfolio – a burdensome requirement, but one that could be useful if the developer wanted to pick and choose specific projects to apply the alternative cost accounting method. Moving forward, the simplified form will apply to all projects in a portfolio.

Meal & Entertainment Deduction

Another tax change in 2023 is the **meal and entertainment deduction**, which reverted back to pre-COVID levels as of January 1, 2023. Most business meal expenses are back to 50 percent, including:

- Business meals with clients or customers
- Food for the office such as soda, coffee, and snacks for employees
- Meals provided in the office for meetings of employees or owners
- Meals while traveling for work
- Meals at a conference

The following business meal expenses can still be deducted at 100 percent.

- Food for employee holiday parties, summer picnics, or team-building events either at the office or another physical location
- Food expenses must be separate from entertainment costs
- Food and beverages to promote public goodwill, like coffee, soda, or snacks for customers
- In-office dinner expenses for employees who work late
- Must be physically in the office to qualify
- Food provided to employees or independent contractors and included in their W-2s as taxable compensation
- Food and beverages to support a charitable cause

Work Opportunity Tax Credit

WOTC, as it's more commonly called, allows employers to recover between 25 and 40 percent of first-year wages for eligible employees. It's a win-win-win: the contractor fills open positions, gets **a tax break worth between $2,400 and $9,600 per employee,** and provides a job with a meaningful wage to someone who may really need it.

Since WOTC is extended at least through the end of 2025, there's still time to use it.

There are three basic steps to claim the credit:

- Hire from an eligible targeted group.
- File a certification request with the state workforce agency.
- Claim the business credit after the employee's first year of employment.

A certification request using Form 8850 must be filed within 28 days of the employee's first day of work.

179D Energy Efficient Commercial Buildings Deduction

The Inflation Reduction Act (IRA) made 179D permanent, expanded its benefits, and added a provision for retrofits of existing buildings.

Moving forward, **179D** will have a lower base deduction amount of $0.50 per square foot but can go all the way up to $5.00 per square foot for full energy reduction amounts plus new labor rules. The new deduction amounts are as follows.

- $0.50 per square foot: 25 percent energy reduction in the overall building
    - Plus an extra $.02 for each percentage point above 25 percent energy reduction up to $1.00
- $1.00 per square foot: 50 percent energy reduction in the overall building
- $2.50 per square foot: 25 percent energy reduction in the overall building **plus** prevailing wage and apprenticeship hours
    - Plus an extra $.10 per square foot for each percentage point above 25 percent energy reduction up to $5.00
    - $5.00 per square foot: 50 percent energy reduction in the overall building **plus** prevailing wage and apprenticeship hours

Building owners can claim 179D every three years with qualifying upgrades. And **starting in 2023, REITs and tax-exempt buildings can also take the deduction, further expanding its use and value.**

Meeting the requirements for the full tax deduction will now mean incorporating prevailing wage and apprenticeship hours for all new construction projects. In some cases, the new labor rules will apply to alterations or repairs as well. This requirement applies to all clean energy tax incentives in the IRA, including 179D, 45L, and several other production and investment tax credits.

As 179D is now a permanent part of the tax code, real estate owners can prepare more long-term tax plans for sustainable building projects.

45L Residential Energy Efficiency Credit

The IRA retroactively reinstated **45L** for 2022 and extended the credit through 2032. Beginning in January 2023, more stringent energy efficiency requirements are in place.

For single-family and manufactured homes, 45L increased to $2,500 and $5,000. To meet the $2,500 tax credit threshold, the building must meet ENERGY STAR® guidelines. To meet the $5,000 threshold, it must achieve Zero Energy Ready Home requirements. Single-family homes built in 2023 or 2024 must adhere to Version 3.1 of the Zero Energy Ready Home program; buildings constructed in 2025 and after would follow the guidelines in Version 3.2. For manufactured homes, achieving the $5,000 tax credit is based on meeting the Manufactured Home National Program requirements in effect two years before the home is built or acquired, whichever is later.

Multi-family homes have several tax credit options depending on the level of energy efficiency and whether prevailing wage and apprenticeship rules are in place.

A single multi-family dwelling can qualify for a $500 tax credit if it meets ENERGY STAR® Multi-family certification standards. This is lower than the previous credit, but there are opportunities to net a higher amount, as noted below.

- $1,000 for each multi-family dwelling that meets Zero Energy Ready Home requirements.
- $2,500 for each unit that meets ENERGY STAR® requirements **and** utilizes prevailing wage rules.
- $5,000 for each unit that meets Zero Energy Ready Home requirements **and** prevailing wage rules.
    - Note that prevailing wage only applies to multi-family dwellings placed in service in 2023 and after.

Prevailing wage requirements will vary based on where construction occurs and the type of worker classification. Project owners are responsible for determining the appropriate wage rates with the Department of Labor.

Apprenticeship requirements may be harder to achieve depending on location. Project owners may still qualify for the higher tax credit without apprenticeship hours, but they must make documented good faith efforts to fulfill the requirements first.

Section 45L Tax Credit: Energy Efficient Home Tax Credit is now extended through the end of 2032.

For projects placed in service in 2023 and after, the minimum apprenticeship hours vary based on which year construction began.

- 2022: 10 percent
- 2023: 12.5 percent
- 2024-2032: 15 percent

Builders can claim 45L for the year the project is placed in service, even if the credit can't be used immediately. It can be carried forward up to 20 years. 45L can also be combined with the 179D commercial building energy-efficient tax deduction, so it's worthwhile to plan ahead and bundle tax incentives when possible.

Section 48 Renewable Energy Credit

Certain tax incentives provide opportunities to reduce project costs and reward building owners for investing in innovative, sustainable technologies.

The **Section 48 Investment Tax Credit (ITC)** is one of these incentives. It was recently updated and expanded in the IRA to lower the cost of installing and operating renewable energy projects (wind, solar, and hydropower equipment).

Prior to the IRA adjustments, the tax credit was worth a maximum credit of 26 percent (2020-2022) of the basis of each energy property placed in service during the taxable year which dropped to 22% in 2023 and 10% in 2024 and beyond. It applied only to projects installed as part of a new solar generation facility. Post-IRA, the base credit is lower and standalone renewable energy projects can qualify.

Even though the base credit has been reduced (6%), there are several benefits that could make the credit more powerful for eligible taxpayers. Different versions of the credit are available depending on when construction begins or when the facility is placed in service.

- Projects placed in service after December 31, 2022 and also begin construction before January 1, 2025: Can still claim the existing ITC under Section 48(a)
- Projects that begin construction after December 31, 2024: Credits available under the newly created Section 48(e)

Section 48(e)'s maximum credit value extends through at least 2033, when it begins to phase out.

Not-for-profit entities and governmental entities can claim a refundable version of the tax credit with similar rules to qualify. For-profit project owners can elect to monetize the credit to another entity under new transferability rules.

Strategies to Navigate the Future

Proactive planning will create more favorable outcomes than a ‘wait-and-see’ approach, even in a normal economy. Cash flow management is one of the best ways to mitigate risk.

Cash Flow Planning

Cash flow forecasting can help construction contractors better manage planning, track costs, manage risk, create budgets, and allocate resources. Consider these tips:

- Identify milestones, budget, and constraints.
- Regularly compare projected vs. actual in terms of costs, timeline, and more.
- Try to identify risks as they become apparent and address them. Risks come in many forms, from interest rate hikes to unexpected weather events, cybersecurity, materials costs, and workforce issues.
- Manage expenses and project revenue.

When conducting cash flow projections, it’s important to include multiple scenarios. Use information gleaned from budgeting and risk management activities to make informed decisions based on data, not hunches. Forecasting helps to identify the best times to buy (or not) materials based on pricing, labor shortages, or work delays, for example.

It’s also wise to run a **financial ratio analysis** to compare performance against industry peers and identify gaps in collections. This is also an opportunity to revisit or set billing terms with suppliers to ensure proper timing between invoice collections compared to payment.

Invoice Timing

A big factor with contractor cash flow planning is when the project owner pays an invoice. Because many contractors frontload the cost of materials and labor for projects, when an owner fails to pay on time, the contractor may struggle to meet its own obligations. Virginia and North Carolina both offer some level of relief in this regard.

In Virginia, project owners now have 60 days to pay contractors after they receive an invoice. Contractors also must follow the 60-day rule when paying subcontractors, or within seven days of receiving payment from the project owner, whichever is earlier. Repealing the “pay-if-paid” clause took effect on January 1, 2023. While it helps to ensure contractors get paid on a timelier basis, their own failure to comply can also result in interest and penalties.

In the same Virginia legislation, contractors working on public projects can be held liable for all payments owed to subcontractors regardless of whether the contractor gets paid. This change can add different layers to contractors' cash flow planning.

North Carolina also prohibits "pay-if-paid" clauses. Even though both Washington, D.C. and Maryland uphold the clause, they also allow conditions to circumvent it by adding "pay-when-paid" clauses in contracts. Especially for contractors doing business in different regions, it's important to understand where risk is concentrated and where there are deadlines for either receiving or processing payments.

Accounting and Finance Technology Transformation

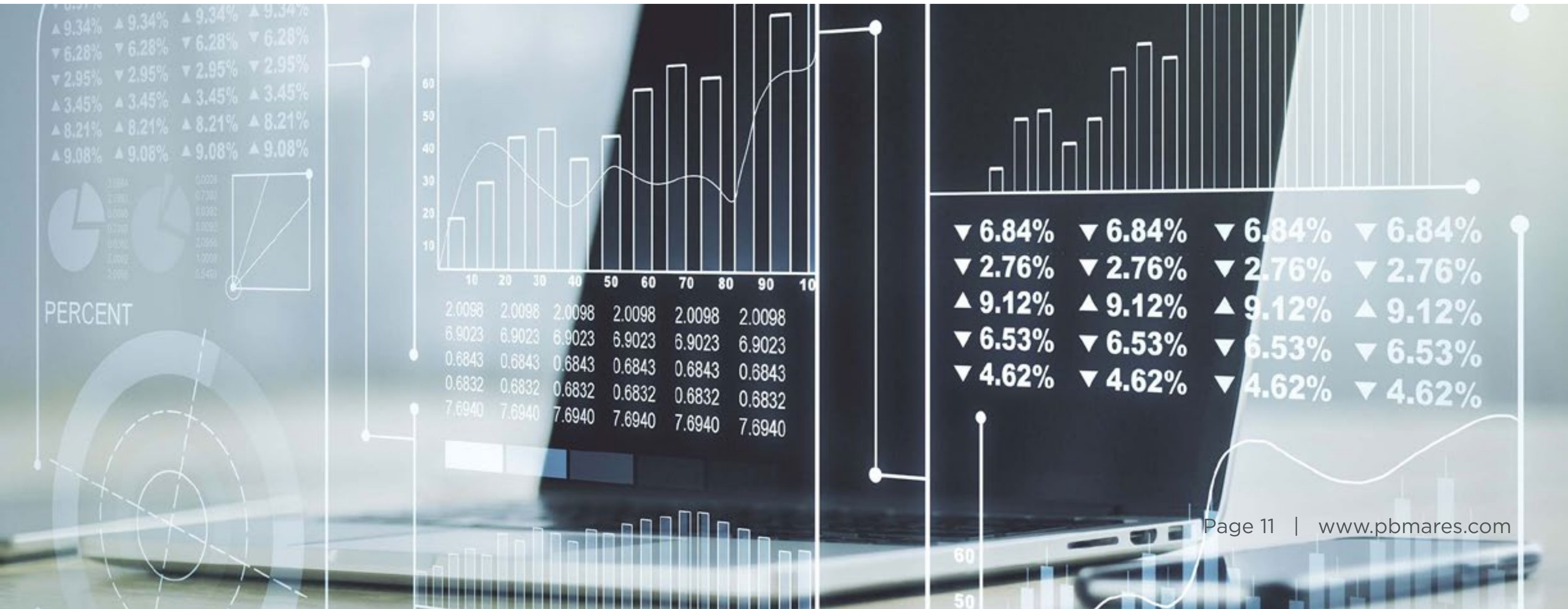
Working with a cloud-based tech platform is crucial to get a daily snapshot of financial performance. More agile technology tools for accounting enable construction and real estate business owners to respond quicker to bids and manage ongoing jobs and properties.

The most common reasons for investing in digital transformation are to:

- Create efficiencies
- Increase profitability
- Improve compliance and regulation, and
- Cut costs

The construction and real estate industry is using technology to improve accounting and finance through:

- Digital documentation
  - Eliminating the need for paper and adding the instant availability of updated documents from anywhere helps to reduce costs and inefficiencies.
- Cloud-based collaboration
  - From the job site to worker training to accounting, the cloud enables quick decision-making and real-time communications.
- Consolidated workflows with more integrated software
  - More connected data means less manual entry, overlap, mistakes, and time.
- Automated A/P and receivables
  - Better technology can produce quicker invoices, payments, and revenue recognition.



Better, more proactive accounting does more than prepare historical financial statements and reports. It helps to anticipate what's next and lower risks. Leaders can identify opportunities and be better prepared to respond to changing market conditions with actionable, real-time insights.

Moving You Forward

For decades, PBMares has helped contractors and real estate developers navigate through the troubled and ever changing waters of this industry. Contractors, developers, heavy construction specialists, home builders, land developers and specialty trades professionals all face their own challenges as they strive for success in the industry, but they have one thing in common: the need for excellent accounting and financial advisory services.

Since every client is different, we strive to listen carefully to each one so we can identify opportunities and communicate clearly the options and choices available. Our goal is to provide all clients with the current, comprehensive information required to make the best decisions for their company.

Construction Services

With PBMares, you get a complete package. Our accounting and assurance teams work closely with tax compliance specialists to ensure the best financial presentation while maximizing your tax savings. We have seen how quickly economic conditions can change and are there to assist with budgeting and forecasting, job costs analysis, strategic planning, succession planning, and business valuations.

Learn more and schedule a conversation with our Construction & Real Estate team today.

What Our Clients Say

"David Nice Builders has a 45-year plus relationship with PBMares. Their professionalism, expertise and guidance has been an integral part of our company growing from a small residential construction company to a nationwide general contractor with projects across 48 states and divisions handling retail, commercial and civil; as well as a second company that manufactures retail fixtures, which compliments the general contracting company.

PBMares provides exceptional service in dealing with all the out-of-state tax returns as well as ongoing advice for overall corporate tax strategies and miscellaneous business accounting needs beyond our seasoned in-house accounting team. They are always very responsive and easy to work with. We consider them a valuable resource as one of our trusted business partners."

~ Deborah Nice, Vice President, Owner, DAVID A. NICE BUILDERS, INC.

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About PBMares

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